CASE STUDY: IF THE BUILD-TO-SUIT FITS...

Once vacated by the original user, build-to-suit properties require a different valuation process.

By Kevin Sullivan

Build-to-suit properties, like custom suits, are wonderful for the original purchaser. A made-to-order suit matches the specific user's size and build and looks just right on him. But try giving that suit to a friend, and the suit that looked great on you may not look as good or fit as well on him.

Similarly, build-to-suit properties may offer limited or no functionality to the next user. The following case study of a freestanding restaurant illustrates the challenges of determining the taxable value of a build-to-suit property.

The property was built in Austin in 2006 for a dine-in hamburger chain with restaurants in the U.S. and Canada. Located at a high-traffic intersection in front of a large shopping center, the restaurant measured 6,780 square feet, according to Travis Central Appraisal District records.

When the restaurant closed its doors in 2011, the restaurant appeared to the casual viewer to be in excellent condition, but the property owner demolished the building. From there, one might have assumed that a different property type would replace it.

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As such, it was surprising to see another restaurant replace the demolished property in 2012. When completed, the new structure measured 6,350 square feet, tax records showed — nearly the same size as the previous building's 6,780 square feet. And the new building, like the old, was home to a national chain, in this case a steakhouse.

In this example, the value to the original user was an investment value and most likely equated to the original cost less physical depreciation. The investment value to the new owner was land value less the cost of demolition.

So how did a relatively new building suffer 100 percent depreciation after only a few years of physical depreciation? In this case, the custom suit was given to a friend, and it just didn't fit.

> Functional obsolescence is inherently built into build-to-suit properties.

The exterior of the first building matched the branded design of a specific chain restaurant, and on the inside, the builder had tailored the kitchen and dining areas to this particular chain. But the new user also wanted a specific exterior design, kitchen and dining area layout to match a different restaurant chain.

So, how then can an appraiser or assessor value a build-to-suit property without putting a nominal or "zero" value on the improvements?

In Texas, the property tax code requires assessors to value properties at market value, not the investment value to any one specific user. "The Appraisal of Real Estate, 14th Edition" states that, "it is generally agreed that market value results from the collective value judgments of market participants...In contrast to market value, investment value is value to an individual, not necessarily value in the marketplace."

In the case of a build-to-suit restaurant, it can be assumed that the pool of potential second-generation users who find functional utility in the property is limited to local restaurateurs or small local chains that do not require a specific look or layout for brand recognition. The market value to these users is likely somewhere in between the physically depreciated cost and the land-less-demolition cost.

This implies that functional obsolescence is inherently built into a build-to-suit property. While measuring the amount of obsolescence is beyond the scope of this article, one strategy is to inventory the number of comparably sized restaurants in the subject's market area and determine the percent of those restaurants that are regional or national chains.

A larger percentage of such chains in the market area indicates a greater degree of functional obsolescence. Using the income approach to value, a larger percentage of regional or national chains implies fewer potential users of the property and, therefore, a greater risk, which can be reflected in the cap rate.

An assessor must consider these factors when determining the market value of a build-to-suit property for property tax purposes. Significant value swings can occur when looking at the investment value for one specific user rather than the market value for a collective of market participants.

Once the market participants who find utility with the property have been determined and weighed against the market participants for which the "suit just doesn't fit," the assessor can determine a proper market value.

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