

SHRINKING RETAIL FOOTPRINT COMPLICATES TAXES

By Kirk Garza, MAI

As brick-and-mortar store operators respond to competition from online retailers, shopping center owners face a mounting risk of unfair taxation when assessors fail to account for retailers' changing preferences for space.

In markets across the nation, select big box and junior big box retail tenants are changing their existing store concepts and shrinking the building footprints of retail shopping center and standalone locations.

Businesses that were once considered strong anchor or junior anchor tenants are even restructuring their business models, renegotiating leases for smaller spaces and closing stores that no longer meet viable internal



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metrics.

JC Penney, Barnes & Noble and Sears have all announced nationwide store closings in 2015, and the merger of Office Depot and Office Max has fueled additional store closings this year.

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Changes Threaten Values

Retailers' new criteria for inline and freestanding stores will almost certainly present a property tax challenge for big box and junior big box space, as store closures and footprint reductions affect demand, market vacancy and lease rates in the sector.

Often, assessors will focus too much on the tenant and what the lease states, instead of remembering that the ultimate goal is to properly value the building and land as of the date of value.

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When working with assessors, it is important to consider that calculations involving existing tenants constitute a leased fee analysis, which is inappropriate for calculating value for property taxes.

On a fee simple basis, which looks at the property and its market position, this type of space may have an entirely different market value.

With that in mind, it is important to know what the space would lease for if available for lease in an open market as of the date of value.

Another important factor to consider is what the property would sell for in an open market transaction on a fee simple basis. In reviewing the assessor's calculations, consider whether any referenced sales of other properties reflect leased fee or fee simple pricing.

Blending leased fee and fee simple sales without a proper analysis can yield conflicting data points, compromising the integrity of subsequent conclusions.

These oversights often result in incorrect market value assumptions and metrics, and lead to artificially inflated property tax values.

Interest Shrinks for Big Boxes

Some tenants have reduced their store footprints by more than 20 percent over the past few years. In part, this adjustment maximizes inventory turnover and sales per square foot.

When looking for new space, certain retailers have also set strict size limits with leasing brokers, and some stores that were once considered anchors are moving into inline retail space.

This type of size restriction can significantly impair a retail property's overall market rent potential if an owner already has a vacant big box or junior box space. These factors are important metrics to consider when surveying rent to arrive at an appropriate market rental rate conclusion.

One way property owners are dealing with unmarketable big boxes is by subdividing the space into smaller suites that better accommodate the growing demand for small retail footprints.

This conversion can be costly, and if

relevant, it is important to discuss the conversion costs with the assessor as of the date of value for the property.

It is also important to consider a proper lease up analysis if the property has substantial vacancy. With store closings triggering an increase in the available retail supply and online shopping continuing to gain market share, a lease up analysis that captures these factors is essential.

An additional issue to consider with the conversion into smaller suites is the depth of the original box and the potential for what some brokers term "bowling alley" space.

Often when the subdivision of big box or junior big box space is complete, new tenants will refuse to lease the excess depth the suite may provide.

In this instance owners are sometimes left with non-leasable space in the rear portion of the original building.

When this happens, it is important to consider excluding this space from the net rentable area of the analysis since the configuration often makes this space impossible to lease.

If subdivision is not an option, be realistic about the future lease up prospects for this type of space and use an appropriate, stabilized vacancy rate in addition to a proper lease up analysis.

Even after observing the points mentioned here, be sure to consider the particular characteristics of the local market before reaching any value conclusions.

As business models for big box and junior box retailers evolve, so must the assessor's approach to valuation. Only after considering all of these factors can the assessor determine a proper market value to the fee simple estate. ■

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