

ARE ALL BRICKS CREATED EQUAL?

Proper functional obsolescence may not be factored into property tax projections provided by the cost estimating services.

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Appraisal districts across Texas often use the cost approach to determine market value for property tax purposes, and when valuing certain commercial properties via the cost approach, county appraisers frequently use cost-estimating services. These services enable appraisers to estimate the cost of the subject property's improvements as if they were new, as well as to determine the depreciation to apply to the subject.

Cost estimators can be a great resource and valuation tool, but the appraiser is likely to reach an incorrect value conclusion using estimates from



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one of these services without also incorporating proper analysis of functional obsolescence.

Functional obsolescence is one of three types of depreciation that measures a building's function and utility against current market standards. Given this, placing all weight on a service's depreciation estimates could lead to



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incorrect assessments that ignore functional obsolescence within the property's total depreciation.

The Trouble With Tables

Cost-estimating services typically provide depreciation tables that contain depreciation data for multiple commercial property types. County appraisers often cite these tables as their main source of depreciation support when using the cost approach.

It is important to know that these tables typically assume all components of improvements for various property types depreciate equally across time. So for example, a brick used in a multifamily or office development will depreciate at the same rate as a brick used in a fast food restaurant or movie theater.

Often-overlooked warnings from these services point out that certain real estate product types are subject to functional obsolescence that occurs rapidly and can significantly reduce the economic lifespan conclusion for the applicable property type. Given this information, a determination of total depreciation for the subject property must include an appropriate functional obsolescence analysis.

Evaluating functional obsolescence involves an analysis of the utility of the improvements and how that degree of usefulness affects total depreciation. As an example, consider the fast food industry, which has evolved drastically over the past few decades.

As fast food real estate models from the '80s and '90s continue to become obsolete, new models have appeared to attract and retain the millennial and Generation Z customer base. Because of this, it is common practice for fast food companies to refresh their store models every five to 10 years, with a complete rebuild taking place every 20 to 25 years.

This refresh-and-rebuild cycle is necessary to fit ever-changing consumer tastes and demands for this real estate product type. While the store refresh may include new flooring, additional exterior decoration and color schemes, a complete rebuild is necessary when the utility of the building no longer fits the current design standards demanded by the market. An economic life of 20 to 25 years may be appropriate to capture the potential functional obsolescence associated with this industry.



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Picture A Theater

Movie theaters are another competitive product type that may be subject to functional obsolescence outside standard physical depreciation. Theaters built in the 1990s and 2000s may struggle to compete with the eat-drink-and-play models that continue to increase in popularity. Across Texas, revenues are declining at select standalone theaters that lack dining, bar and event options.

Theaters without these features often lack the capacity to add a commercial kitchen, bar service or bowling alley into their existing structure, which limits the property's utility based on market tastes and preferences. These older theaters may also have large projection rooms previously used to house large equipment and film reels. With the arrival of digital cinema, most projection rooms now require less space to house and project content.

Auditorium spaces are also evolving, based on the capacity to house premium luxury sections or reclining seats with independent power modules. These popular seating features have resulted in auditoriums having less seating capacity, given the additional space required for each seat. Clearly, it is important to analyze and recognize any applicable functional obsolescence that could affect this property type.

Real estate product types continue to evolve with consumer standards and tastes. It will be important to consider the impact these requirements have on a building's utility over time.

Cost-estimating services are a great tool frequently used for valuation, but it's key to know what is and what isn't reflected in their information. Once assessors realize this distinction, they can apply proper analysis of total depreciation in their cost-approach determination of a property's market value. ■

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