Distressed Properties, Vacancy Shortfall, and Entrepreneurial Incentive

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A commercial property that suffers from below-market occupancy typically will not sell for as much as an identical commercial property with stabilized occupancy. Where property tax laws require a fee simple valuation of commercial property based on market rents, the assessed property value should reflect a valuation adjustment for any below-market occupancy. Estimating the effect of below-market occupancy on the value of commercial property requires an additional procedure in the real estate appraisal analysis: after first valuing the subject property at stabilized market occupancy, the real estate appraiser should then analyze the subject property at its below-market occupancy. The difference between market occupancy and below-market occupancy is referred to as "vacancy shortfall." This discussion explains the vacancy shortfall analysis, including consideration of a valuation adjustment for the entrepreneurial incentive that a typical investor would require to bring a destabilized occupancy property up to stabilized occupancy.

Introduction

Let's consider the values of two identical office towers: one fully leased by multiple tenants at market rents, and another completely vacant. Assuming all else is equal, the fully leased office tower will always sell for more than its vacant twin property.

But will that price differential mean lower property taxes for the vacant office tower? The answer depends on how the taxing jurisdiction determines values for property tax purposes.

In some taxing jurisdictions, "fee simple" may mean that commercial property should be valued as if vacant and available, as if the property is unencumbered with any leasehold interests. In those taxing jurisdictions, the value of the fee simple estate for both office towers should equal the market value of the vacant office tower.

In contrast, many taxing jurisdictions interpret "fee simple" as requiring that commercial property be valued as if leased, at market rents, as of the valuation date. In these taxing jurisdictions, the vacant office tower should have lower property taxes than its fully leased twin. That is, the vacant office tower should not be taxed at a level as though it enjoyed income from market rents at market occupancy when it is actually suffering from below-market occupancy.

Taxing the vacant office tower at that level would ignore market realities regarding how buyers and sellers determine the value of commercial property with below-market occupancy.

This discussion explains the vacancy shortfall analysis. The vacancy shortfall analysis is used to estimate the reduction in value due to below-market occupancy.

The vacancy shortfall analysis is the same analysis that buyers and sellers use to negotiate the selling price of a distressed property. This same analysis should apply when appraising a distressed commercial property for property tax purposes.

The analysis involves a two-step process:

1. Estimate the value of the subject property based on a stabilized level of market occupancy (i.e., estimate the "stabilized value" of the property).

2. Estimate the amount of vacancy shortfall to deduct from the stabilized value indication to account for the costs and risks required to bring the subject property to stabilized occupancy.

Step One: Estimate Stabilized Value

The first step in valuing a commercial property with unstable occupancy is to determine the value of the property assuming stabilized occupancy.

This procedure is performed because, in order for vacancy shortfall to be feasible to cure, the value of the property with stabilized occupancy should be worth more than:

1. the value of the property with below-market occupancy plus
2. the costs required to stabilize occupancy.

In order to estimate the value of the property with stabilized occupancy, the real estate appraiser should first determine the highest and best use of the property. Typically, the highest and best use of commercial property is assumed to be *as improved, with stabilized occupancy*.

In all aspects of the commercial property valuation analysis, real estate appraisers attempt to mimic the valuation methods used by market participants to the extent possible.

Sometime, however, these real estate appraisal methods may differ from valuation methods used by market participants. This is because market participants rarely buy or sell the fee simple estate in real property.

Instead, depending on the type of commercial property, market participants more typically buy or sell a leased-fee interest in real property. Investment sales of properties subject to leases are sales of the leased fee.

For apartments, leases tend to be short term, and there may not be a significant difference between net operating income based on the leased-fee contract rent and the fee simple market rent. For retail, industrial, and office properties, long-term leases can differ significantly from market terms as of the valuation date.

Properties leased to credit tenants for lengthy terms typically have much higher leased-fee values than those leased for shorter terms, even if the rents are similar. For these property types the valuation exercise for property tax assessments is usually very similar to how market participants estimate the property's value, with the exception of any differences between contract lease terms and market lease terms.

When market participants buy and sell property that is closely comparable to the subject property for property tax purposes, real estate appraisers typically give most weight to the valuation approach that is most heavily relied on in the marketplace. Typically, the income approach is used to estimate the value of income-producing properties.

The cost approach, which is often used by property tax assessors, is infrequently used by the most probable buyers of income-producing properties.

The sales comparison approach is widely used, but its use varies in reliability depending on the availability and quality of sales data.

All three real property valuation approaches can be used to estimate the stabilized value of a subject property. This is because data regarding stabilized properties are typically more readily available than data for distressed properties.

In the income approach, the real estate appraiser will use market rents and stabilized occupancy rates. The subject property's actual contract rents may be higher or lower than market rents. Market rents can be estimated based on an analysis of comparable property lease rates near the valuation date.

In most jurisdictions, any difference between the subject property's actual contract rents and market rents would affect the value of the leased-fee interest in the property, not the fee simple estate that is the subject of the real estate appraisal.

The income approach direct capitalization rate should be derived from market-based data of comparable, stabilized properties. This is because, in this two-step analysis, any added risk due to destabilized occupancy will be accounted for in the amount of vacancy shortfall, not in the direct capitalization rate.

In the sales comparison approach, the real estate appraiser will rely on property sales that are sufficiently comparable to the subject property. Inherently, these comparable sales will reflect who the most probable buyer is for the subject property.

For example, in some industrial property markets, the most probable buyer may be an owner-operator (i.e., a strategic buyer—as opposed to a financial buyer). Owner-operators will often pay more than investors (i.e., financial buyers) for these vacant industrial properties. This is because the vacancy shortfall does not affect their purchase decision.

However, for most income-producing properties, sales of stabilized properties far outnumber sales of unstable properties. This weighs in favor of the real estate appraiser's use of sales of stabilized comparable properties.

If the appraiser's data include sales of both stabilized properties and unstable properties, then upward adjustments to reflect a stabilized value are appropriate for the sales of unstable properties. This adjustment should be consistent with the vacancy shortfall analysis procedures outlined below.

The income and sales comparison approaches offer the only opportunities for the real estate appraiser to follow how buyers and sellers negotiate selling prices for properties with below-market occupancy. The appraiser can discuss with the buyer and seller the effect on the sale price caused by unstable occupancy. Each party to the sale may have a different view of that effect.

To estimate a stabilized value from the cost approach, the real estate appraiser should consider the subject property's cost new, including an entrepreneurial incentive profit margin and all forms of depreciation.

Depreciation includes physical depreciation, functional obsolescence, and external obsolescence.

Physical depreciation will account for normal aging. It can be separated into short-term and long-term components.

Functional obsolescence will account for loss in value due to design. For example, an elbow space in a retail center will usually lease for significantly less than an identically sized space with normal exposure. Both physical depreciation and functional obsolescence can be curable or incurable.

External (sometimes called economic) obsolescence is value loss from factors outside of the property itself. This can be the effect of an oversupplied market, for example, which can result in high vacancy, whether throughout the market or concentrated at a specific property.

High vacancy can be cured by leasing the property, unless the high vacancy is the result of incurable obsolescence. The effect on value of curable high vacancy is addressed in the second step of the analysis.

What exactly does "stabilized occupancy" mean? It generally means the occupancy level of a new property that is reached after the initial lease-up period, and that is reasonably expected to continue into the future with the proper marketing, management, and maintenance expenditures.

Typically, stabilized occupancy is estimated to be about 95 percent or less, but this estimate is highly dependent on the property market, property type, and property location.

For example, office, industrial, retail, or multifamily properties are usually assumed to have 95 percent stabilized occupancy (i.e., 5 percent vacancy). Senior living and self-storage properties are often assumed to have lower stabilized occupancy, such as 90 percent or less. Chronically distressed property markets may have even lower levels of stabilized occupancy.

Lenders' underwriting assumptions of stabilized occupancy are often an acceptable market indication of stabilized occupancy. This is in part because lenders' assumptions of stabilized occupancy can directly affect market prices. In other words, lender's assumptions affect market prices because investors rarely purchase commercial property without lender financing.

Consequently, if lenders generally assume 95 percent stabilized occupancy for a subject property type, that may be an appropriate assumption to rely on in a vacancy shortfall analysis, even if the subject property's actual vacancy is different (whether higher or lower).

Not only do lenders underwrite property loans based on normal vacancy on a stabilized basis, but they must, under federal law, require that appraisals reflect a vacancy shortfall deduction for properties with below-market occupancy.

As stated in the federal guidelines governing financing appraisals of real estate, "the appraiser must make appropriate deductions and discounts to reflect that the property has not achieved stabilized occupancy."[1]

The federal guidelines also require "consideration of the absorption of the unleased space" and deductions or discounts for "items such as leasing commission, rent losses, tenant improvements, and entrepreneurial profit, if such profit is not included in the discount rate."[2]

At the end of the first step of the analysis, the real estate appraiser reconciles the various value indications to conclude the value of the property as though it enjoyed stabilized occupancy. By assuming stabilized occupancy as the basis of each value indication, the appraiser can reconcile values that are directly comparable to each other.

Trying to reconcile a stabilized value from a cost approach, for example, with a value from another approach that reflects below-market occupancy, would be confusing and could lead to error.

During the value reconciliation procedure, the real estate appraiser should give the most weight to value indications:

1. based on the quantity and quality of available data and
2. derived from valuation methods that best match the methods used by the most probable buyer of the subject property.

Step Two: Determine the Vacancy Shortfall

Atypically high vacancy at the time of sale can materially affect the price that a typically motivated buyer will pay for an income-producing property.

The second step in the analysis calculates this effect on the property's market value by estimating the vacancy shortfall. The vacancy shortfall consists of the costs that would be required to bring the property to stabilized occupancy, including an appropriate margin for entrepreneurial incentive.

The costs required to bring the subject property to stabilized occupancy include the lease-up costs that would be faced by a purchaser of the property. In estimating the lease-up costs, a prospective buyer would consider not only the nonleased units at the property but also the leased units that are not occupied (these units are often called "dark" units).

Let's consider, for example, a single tenant retail store. If this property is leased on a long-term basis, but the operator relocates to a new, modern format in the same trade area, an investor-purchaser will account for certain releasing costs that will likely need to be incurred.

To estimate the lease-up costs that are properly deductible from a stabilized value conclusion, the real estate appraiser should consider both direct costs and indirect costs.

Direct costs include tenant improvements that would likely be required for new leases based on a market lease analysis and normal commissions that would need to be paid to leasing brokers.

Indirect costs (or opportunity costs) would include any lost revenue incurred until the property is leased. This includes any rent loss due to vacant or dark units (based on market rent and the estimated absorption period), lost expense recoveries, and any concessions, such as free rent.

For units that are leased but dark, there are some additional considerations.

First, there is some level of income from the tenant until the end of the lease term. Second, the estimated absorption period may need to be adjusted to account for the unit's interim occupancy until the end of the lease term.

The estimated absorption period should consider whether the lease allows the owner to recapture the unit and/or show the unit to prospective tenants. The inability to show the unit to prospective tenants will obviously lengthen the absorption period.

One finer point of the vacancy shortfall analysis is to consider what percentage occupancy achieves stabilization and how that stabilization should be modeled. If a property is currently 80 percent occupied and stabilized market occupancy is 95 percent, should the vacancy shortfall be modeled on 20 percent vacancy or 15 percent vacancy?

The answer is that the real estate appraiser should follow the market. If the most probable buyers are basing their property buying decisions on 15 percent vacancy (calculated as the 95 percent stabilized market occupancy less the current 80 percent occupancy), then a 15 percent vacancy should be used.

For properties with multiple vacant units that comprise a larger vacancy shortfall, this is practical. For unstable properties where the vacancy is comprised of a single unit, this is not practical. A single tenant property is not going to realize 95 percent occupancy.

Another example would involve an anchored retail center. If the anchor space comprising 60 percent of the total property was vacant, while the remaining retail space remained full leased, then the lease-up costs would match what would be required to lease only the vacant anchor space.

At the end of the second step of the analysis, the real estate appraiser should include in the vacancy shortfall a profit margin for entrepreneurial incentive. This incentive is required to compensate the most probable buyer of the subject property for the risks associated with investing in a distressed property.

"[F]ederal guidelines governing financing-related real estate appraisals require consideration of entrepreneurial incentive for properties with vacancy problems."

The appraiser then deducts the vacancy shortfall from the stabilized value indication. The resulting value reflects the property's as-is market value (i.e., the property's market value based on the actual level of occupancy as of the valuation date).

Entrepreneurial incentive plays an important role in most investors' determination of the offer price for distressed properties. If investors fail to include entrepreneurial incentive when analyzing distressed properties, transaction costs (such as real estate transfer tax, brokerage fees, etc.) could result in investors losing money on any subsequent sale of distressed properties once stabilized.

As mentioned above, federal guidelines governing financing-related real estate appraisals require consideration of entrepreneurial incentive for properties with vacancy problems.

Though not discussed much in the real estate appraisal literature, at least two journal articles address this issue. These articles discuss the fact that the purchaser of a distressed property assumes entrepreneurial incentive as an important factor in the sales price to account for the risk and effort of bringing the property to stabilized occupancy.

William Ted Anglyn has written two articles on this subject: "Analyzing 'Unearned' Entrepreneurial Profit"[3] and "Distressed Property Valuation Issues."[4]

These journal articles explain that purchasers of distressed properties require compensation for the skill and risk involved in purchasing and stabilizing such properties and, therefore, it is appropriate to deduct a market-based amount for entrepreneurial incentive from the purchase price.

The authors of this discussion are unaware of any real estate appraisal literature that claims the opposite position (i.e., that entrepreneurial incentive does not factor into sales prices for distressed properties).

Market evidence from distressed property transactions further support the inclusion of entrepreneurial incentive in the vacancy shortfall analysis. The percentage of entrepreneurial incentive appropriate for a given property should be supported by market evidence from comparable transactions.

Real estate appraisers should interview market participants regarding the level of entrepreneurial incentive profit margin they typical require. Buyers will often seek as much profit as possible as compensation for the risk they are taking when acquiring distressed properties.

If there is competition for a property, however, the parties will usually negotiate and settle on a lower profit margin. The profit margin range is very dependent on the level of risk and the negotiation skill of the transaction parties. The entrepreneurial incentive profit margin typically can range from as low as 20 percent to over 100 percent of the lease-up costs.

Case Studies on Vacancy Shortfall Analysis

While sales of stabilized properties far outnumber sales of unstable properties, the market often demonstrates the impact of below-market occupancy on value.

Two case studies drawn from actual experience illustrate the type of market evidence that appraisers can derive from careful verification and analysis of distressed property transactions.

Case Study 1

The sale and resale of the same property shows how a near-term vacancy rollover affected value. The property was a multitenant retail center in a suburban market across the street from a regional mall. The retail center contained about 142,000 square feet on 11 acres.

In late 2011, the property was listed for sale at $18.5 million. It was extensively marketed and exposed to the market for a sufficient amount of time to receive multiple offers. The property was initially put under contract in February 2012 at $15.4 million with a 30-day due diligence period followed by a 60-day financing contingency.

A subsequent amendment in March 2012 lowered the offer price and waived the due diligence contingency. The offer was accepted and the transaction closed at a price of $15 million. This sale meets all of the criteria for a market value transaction.

While the property was stabilized at the time of sale, it was known that Office Depot would be relocating to a smaller store in a center a block to the south. So, effectively, occupancy was going to be 77 percent. This lowered the center's market value.

After this sale, the new owner stabilized the property by way of a new 10-year lease of the former Office Depot space to Total Wine.

Additionally, Big Lots had a termination option in year five (February 2014) that was eliminated, and PetSmart exercised its next two options, providing 12 years of remaining term. These changes significantly improved the center's risk profile.

With the execution of the Total Wine lease, the property was relisted for sale at $25.1 million. A purchase and sale agreement was negotiated with a regional investor. The purchase and sale agreement was executed in October 2013 at $24.5 million.

After the buyer's due diligence, including the property condition report that identified near-term capital requirements of $1.0 to $1.7 million, the buyer sought a lower price of similar magnitude. The seller resisted and the two parties settled on a discount of $595,000 to arrive at the closing price of $23.9 million.

Thus, stabilizing the property's occupancy contributed to a sale price nearly $9 million higher than the sale of the same property with unstable occupancy 19 months earlier.

Case Study 2

A sale of a retail property suffering atypically high vacancy indicates how buyers and sellers apply the vacancy shortfall analysis, including an entrepreneurial incentive profit margin, in determining a selling price. This sale was of a multitenant retail center in a suburban market across the street from a major anchor.

The center contained 10,000 square feet on 0.74 acres. The property was demised for eight spaces ranging from 1,200 to 1,600 square feet.

In 2014, the property was only 40 percent leased when it was listed for sale at $1,500,000. After a normal exposure period, a purchase and sale agreement was executed in January 2015 at $1,350,000. The sale met most of the criteria of a market value transfer with the possible exception of a typically motivated seller.

The seller was a lender that had foreclosed on the property in 2012. However, given that other offers at the time were around $1,300,000, it is unlikely that a higher sale price could have been achieved.

In this case, the comparable sales approach supported a stabilized value of $1,820,000. And, the income approach using market rent for the vacant space, a typical 5 percent vacancy, and a capitalization rate of 7.7 percent supported a stabilized value of $1,810,000.

The final purchase price implied a vacancy shortfall of $460,000 (calculated as the stabilized value of $1,810,000 minus the purchase price of 1,350,000).

This vacancy shortfall amount included lost rent, lost recoveries, tenant improvements, leasing commissions, and an entrepreneurial incentive profit margin. The absorption for this property was estimated at nine months downtime and included three months of free rent.

Exhibit 1 summarizes the vacancy shortfall analysis.

Clearly the property's listing price of $1,500,000 was an effort to account for some of the vacancy shortfall. If the property were able to sell at the list price, the implied entrepreneurial profit margin would have been about 35 percent of the full lease-up costs, or approximately $80,000.

This $80,000 implied entrepreneurial incentive profit margin is calculated as the stabilized value of $1,810,000 minus the lease-up costs of $227,592 minus the list price $1,500,000.

However, the property did not sell at the full listing price of $1,500,000. The actual sale price was $1,350,000, indicating that a 100 percent entrepreneurial incentive profit margin on the full lease-up costs was required.

The level of entrepreneurial incentive profit margin required is a function of risk. The higher the risk, the higher the reward.

A minor occupancy shortfall of 90 percent in a market where stabilized occupancy is considered to be 95 percent, may require an entrepreneurial incentive profit margin in the range of 10 percent to 20 percent.

As Case 2 demonstrates, this margin will ramp up significantly for higher levels of vacancy.

Also, while an entrepreneurial incentive profit margin of 100 percent to 125 percent may seem very high in terms of the percentage, it is not an extraordinary windfall. If the buyer of the unstable property was able to resell the property upon stabilization, the net profit would be based on the net proceeds of the stabilized sale less the seller's cost basis.

In this case, the stabilized sale profit would be $1,810,000 less normal sale costs of 5 percent, or net sale proceeds of $1,719,500. The seller's cost basis would consist of the purchase price of $1,350,000 plus the direct lease-up costs of $142,392 (leasing commissions, tenant improvements, and expenses not recovered) for a total cost basis of $1,492,392.

Exhibit 1
Vacancy Shortfall Analysis

Stabilized Value		**$1,810,000**
Total Rentable Area		10,000
Leased	40%	4,000
Vacant	60%	6,000
Vacancy Shortfall	6,000 sq. ft.	
Absorption Estimate - Months		18.0
Straight-Line Average Downtime		9.0
Lost Rent at Market ($/sq. ft. per month)	$1.18	$63,900
Free Rent (3 months)	$1.18	$21,300
Monthly NNN Rate	$0.47	$25,252
Commissions	6%	$27,140
Tenant Improvements	$15.00	$90,000
Subtotal of Full Lease-Up Costs		$227,592
Entrepreneurial Incentive Profit Margin	100%	$227,592
Total Vacancy Shortfall Absorption Deduction (rounded)		**$460,000**
Purchase Price		**$1,350,000**

Subtracting the seller's cost basis from the net sale proceeds results in a net profit of $227,108, or about 15 percent of the seller's cost basis.

If the entrepreneurial incentive profit margin in the vacancy shortfall analysis in this case was, say, 25 percent, keeping all else equal, this would imply a purchase price of around $1,530,000.

In this scenario, the net profit from purchase to resale would only be about 3 percent. It would not take much to go wrong in this case for this minor level of net profit to be eliminated.

Conclusion

For commercial real property that has below-market occupancy, real estate appraisers often have a strong case to apply a vacancy shortfall deduction in the property tax valuation if the property is being assessed as though it is at stabilized occupancy.

By applying the above described vacancy shortfall analysis when valuing distressed property, the real estate appraiser emulates the analysis that buyers and sellers typically use in market transactions to negotiate the sales prices of income-producing commercial properties with high vacancy at the time of sale.

Omitting the vacancy shortfall analysis—or even omitting the analysis of entrepreneurial incentive that a buyer would require for the added risk, skill, and effort involved in bringing the property to stabilized occupancy—would result in an overvaluation of the subject real property.

Notes:

1. Interagency Appraisal and Evaluation Guidelines at 36 (Dec. 2, 2010), available at https://www.fdic.gov/news/news/financial/2010/fil10082a.pdf.
2. Id.
3. William Ted Anglyn, MAI, "Analyzing 'Unearned' Entrepreneurial Profit," *The Appraisal Journal* (July 1992): 368. The article also discusses William L. Pittenger's seminar presentation "Contemporary Applications of Valuation Analysis" [1990] in Atlanta, Georgia.
4. William Ted Anglyn, MAI, "Distressed Property Valuation Issues," *The Appraisal Journal* (Spring 2005): 210–215.

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