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Tax Policy

Estimating the return on investment can be a challenge for commercial real estate investors. In this article, Michael Allen of Ryan, LLC, discusses raw capital expenditures as an indicator of the risk of future discounts to return on investment.

When Should You Use “Raw” Capital Expenditures In the Valuation of Commercial Real Estate?



BY MICHAEL ALLEN

Whether an investor is underwriting a potential commercial real estate (CRE) acquisition or a tax assessor is preparing a real property tax assessment, careful consideration should be given to the current condition of the subject property, the cost to cure any adverse conditions found therein, and any required future capital projects. Why? Because unless the subject property’s current condition can fully sustain the projected income stream over the entire investment period being underwritten by the buyer, then either the sales price must be adjusted for the costs to cure those items or the indicated corrective work must be completed before closing. Failure to do so will result in a likely future and unintended discount of the yield anticipated by the buyer and/or cause an inflated assess-

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ment for property tax purposes. This in turn will produce a retroactive compression of the acquisition “going in” capitalization rate (Cap Rate) that the buyer thought he/she was using, and thereby unexpectedly reduce the overall assumed Return on Investment (ROI) of the transaction. Anticipated future capital expenditures (Cap X) can be a useful measure of that risk and of the current cost of such required adjustment(s), but what kind of Cap X should be used?

Typically, there are two quite different types of Cap X to consider: budgeted capital expenditures (Budgeted Cap X), which is the amount that the owner/manager of the property has *already approved* to be spent annually over a defined period of time and the yet unbudgeted and unfunded capital expenditures (Raw Cap X), which is the *total cost* to cure all currently identified items at today’s values that will eventually need to be corrected, replaced, and fixed to maintain stabilized annual NOI. Depending on which one of these you choose, the resulting valuation estimate can be vastly different.

What are “Costs to Cure”?

Nothing lasts forever. Consider a property’s HVAC system, roof, plumbing, elevator, etc. All of these need to function constantly and well for the owner occupier or the tenant of that property to get the functionality that they bargained for when they bought or leased their premises. The question is simply when, not if, these and similar items will wear out.

A prudent investor needs to make some accommodation and plan for the eventual rainy day (again, the roof comes to mind particularly once the warranty has expired, and there have already been multiple layers of repair done to it) when he or she will have to incur a significant capital expense. Absent an actual “sinking

fund” that is being maintained and funded, or one that will be maintained by the new owner to offset the negative conditions purchased at a discount, then a buyer will be inheriting a hidden future capital call if these items hit during their hold period.

As previously mentioned, having to pay for these future costs out of current NOI or by way of investor capital call will also reduce ROI. Some buyers will take such a risk in exchange for a discounted sales price. Unfortunately, assessors often miss the need for this type of adjustment for property tax purposes.

Even if no cash is expended during the hold period, buying existing property deficiencies at full market price can impact resale values considerably. Another way to look at this surprise impact is to see the actual/potential reduction in NOI during the buyer’s hold period as a drag on the eventual Terminal Cap Rate and/or resale price because the next buyer is probably going to underwrite his/her purchase correctly and get an adjustment for the deferred items. Adjusting then for impaired future NOI will push upward the Terminal Cap Rate and thus its resale value down. Better to deal with any such risk as part of the original acquisition and/or as part of the ongoing assessment appeal process. So if a buyer gets squeezed both on the original purchase and then upon eventual resale because he/she failed to identify and adjust for the negative impact of these impairments to NOI, the resulting discount on expected ROI could be considerable and turn the investment into a loser.

Of course, many sellers in today’s frothy CRE market will say that their property is being sold “As Is” and that their proposed sales price already prices in such condition issues, but unless this is expressly addressed in due diligence, the potential buyer is looking at a possible future nightmare. This is particularly likely in a competitive “seller’s” market where multiple offers on the same property are received. Investors should not be asking: “What is this property’s market value today, based on capitalized NOI, but rather what price would it make sense for me to pay to achieve the kind of return over time that we are seeking?”

The Leaking Swimming Pool Theory

This swimming pool analogy assumes that no typical, prudent, and knowledgeable investor will pay full asking price for a house with a disclosed leaky swimming pool problem. Either the seller will discount the sales price by the cost to cure and restore the pool to working order, or the buyer will require the repairs to be made to an acceptable market standard prior to closing.

This same theory applies to CRE, where future income streams rather than the land and its improvements are usually the main motivation for the acquisition. “Pride of ownership” rarely plays any part in the CRE underwriting and valuation, which typically focuses exclusively on likely future cash flow generation over a defined holding period and then discounted to a current value at a market discount rate.

The driving issue is of course **RISK**. This includes the risk that the underwritten NOI will not materialize. The risk that the assumed ROI required to invite the capital/debt to the transaction will not be fulfilled. The risk that the investors may have to pony-up significant and unexpected capital calls during the hold period. Such calls

are always unwelcome and will retroactively destroy the originally anticipated investment yield.

Money is fungible. It goes to where the best and safest risk adjusted returns are. This is why junk bonds attract much higher interest rates than say U.S. Government bonds. Similarly, in CRE, brand new, triple leased buildings with in place, long-term tenant(s) occupying the entire premises will typically attract lower going in cap rates from investors, as compared to dark and vacant big box retail properties that have been sitting empty for many years, with a leaking roof, encapsulated asbestos, and a need for complete repurposing in the market place, etc.

Regrettably, the reluctance to fully fund replacement reserves for older buildings has grown in recent years as the pressure to squeeze maximum ROI out of CRE investments has been driven in part by historically low cap rates used to purchase such properties. Many take the gamble that the problem will not become ripe during their ownership so that the corrective costs can be passed along *without* any value discount to the next buyer. That can be a risky assumption depending on market swings and requirements.

To win competitive bidding situations, many aggressive investors in today’s over-heated CRE markets might make that gamble. That approach results in many major building condition issues being kicked down the road, hopefully to the next buyer, who it is assumed will be as dazzled by the future NOI projections and therefore not look under the hood too closely. This strategy probably works for trophy buildings but not for more common fare properties.

Furthermore, some buyers, particularly international and institutional ones, may have longer investment hold criteria, and they in particular would be well advised to be even more diligent in factoring these future costs to cure as part of their underwriting. Few of them seem to do so as they currently look forward to receiving a transactional ROI that barely matches today’s rate of core inflation rate. Their primary investment criteria seem to be the “safe harbor” of their capital and not yield generation from such investments. The problem will become even more acute when the current CRE bubble ripens and bursts—and it will.

Property Tax Impact

Of course, the post-closing nightmare gets worse if the property’s annual real property assessment, and the property taxes based thereon, is also inflated by the assessor’s refusal on revaluation to adjust for the impact of these costs to cure on value for assessment purposes.

Absent compelling proof, most assessors are unwilling in the current market conditions to make adjustments for the costs to cure adverse conditions that are in excess of the replacement reserve that is usually already baked in to their annual NOI assumption. This is usually the wrong answer.

Although this lack of adjustment is arguably appropriate in newer, well maintained properties with shorter-term tenants, in older or under-maintained buildings with high wear and tear tenants this can produce inflated assessments and that in turn translates into inflated taxes that ultimately are passed through to the tenants.

This risk factor and negative influence on value can be addressed either by adding a risk rate to the base cap

rate for buildings that have well documented and significant above average Cap X requirements or by deducting the present value of the corrective repairs as of the date of the assessment as a “below the line” adjustment to the value indication produced by dividing the stabilized annual NOI assumption by the selected cap rate without a risk rate added.

Either way will work, but failing to do either produces inflated property taxes and negatively impacts the local non-credit tenants in the property, which is usually in conflict with the political protocol being messaged to the taxing jurisdiction. Yet this happens repeatedly, and nationally, even when the need to adjust is well documented.

Assessors rarely if ever inspect the inside of the properties they assess. They have too many to value, and their mass appraisal methodology does not require it. However, on appeal such adjustments are required. Alerting and documenting such adverse conditions to the assessor regularly, consistently, and in a well-supported manner should result in these issues being properly dealt with for assessment purposes. Including this data in the filing of any required Income and Expense surveys is a particularly effective and best practice to achieve this goal.

Possible Solutions

Incurable or Hard to Estimate Cost to Cure. The best way to adjust value for incurable or hard to estimate cost to cure items that can impact future NOI is to merely add a risk rate to the going in capitalization rate used in the Income Approach to Value. This is not easy to do because determining the amount of such a risk rate is very subjective. However, in cases where the condition just cannot be fixed physically or economically, or is external to the subject property, then such a risk rate addition may be required and has to be negotiated with the seller/assessor using the best data and expert testimony available.

Curable Adverse Conditions and Their Costs to Cure. In many CRE properties, adverse conditions are curable, and it is possible to identify and support the cost and timing needed to address these issues and prevent future drains on NOI. Of course, the better documented these costs to cure are, the more likely the seller/assessor is to accept an adjustment. So where do you go to find the most credible amount of appropriate adjustment to account for all of the potential negative impact on future NOI?

A typical shortcut used particularly by assessors (and some buyers) is to ask for the currently budgeted Cap X for the subject property, as well as a list of all actual capital expenditures made in recent years as a clue to separate what really needs to be fixed from any artificial construct for a property tax appeal or an unreasonable attempt to deflate the indicated sales price. Unfortunately, this gives you a retroactive rather than a prospective view of the risk.

What Is Raw Cap X? *Raw* (or un-budgeted) Cap X is usually what the building’s engineer or the on-site management teams *already* know they need to be spend to fix *all* of the existing accrued operating problems of the property. Spending this money greatly reduces the risk

of future surprises from unexpected building service and component failures. It is the best estimate to use in avoiding future ROI discounts.

Budgeted Cap X, on the other hand, reflects only the partial amount of the total ask to cure all deficiencies that has already been agreed to be funded in a given year by ownership. For instance, if it is determined that the roof on a building needs to be replaced in about ten years, then maybe only 10% of the total cost to replace it would be put into budgeted expenses each year.

The danger in today’s CRE market is that if you miss the need to fix something major during your anticipated hold period and it is a big time expense, then the additional equity that you need to invest to fix it reduces NOI and could wipe out your entire yield on the investment. There is no safety net if you fail to identify and discount for those future capital expenses that would be in excess of the typical wear and tear amounts addressed in the annual reserves.

The ability to get these credits depends on how the CRE market is at that time. In an over-heated market, sellers may just say “tough,” whereas in softer markets this may be negotiable. However, there is no excuse for assessors in arriving at their periodic ad valorem real property tax assessments not to address these issues if supporting facts and data have been previously submitted to them. It is a best practice in taxing jurisdictions where Income & Expense (I&E) filings are required for CRE to proactively list and identify on a consistent and regular basis the Raw Cap X that will be needed in the future to return the subject property to a stabilized condition.

Because assessors rarely look inside a building that they are valuing for tax purposes, if you do not tell them about condition issues, then they do not know to address them—even if they want to. On the other hand, proactively disclosing the issues and the entire Raw Cap X needed to cure them on the Income & Expense (I&E) survey makes it more likely that the property owner will get an adjustment to the proposed assessed value, if only on appeal. In fact, consistent and diligent reporting of these issues in the compliance process may reverse the burden of proof so that the assessor has to defend why no adjustment was made despite repeated and formal notice of the issues having been previously given. Obviously, if a multi-year record of these issues is built up, then more weight will be given to such issues as a basis of an assessment challenge.

Is There a Need to Discount to Present Value? Many assessors and most sellers will argue that even if the corrective cost to cure is a real issue for the next buyer that the full cost thereof should *not* be deducted as a lump sum in favor of only adjusting for the discounted present value of those items. The idea being that if you are going to pay for this work over many years, then the buyer’s present value for that work is much reduced, and to credit the full current value of that work would give the buyer a windfall.

Apart from the issue of inflation that is likely to increase with higher interest rates, and offset the present value discount, this is a difficult position to defend. It is akin to arguing for an adjustment to fix only half the swimming pool because you choose or have to fix the entire pool over a prolonged period of time. It is an illogical argument, yet it is made almost systematically by assessors for property tax purposes.

Conclusion

1. Failure to fully address condition issues can lead to a seller being able to capture part of the buyer's potential resale value or yield as part of the original purchase price. Then, on resale if those same items are then properly treated and discounted by the new buyer, then the original buyer's yield can be further reduced. Addressing deferred cost to cure items in the original sale is critical to avoiding this pitfall.

2. Raw Cap X is a better indicator of the risk of future discounts to ROI than budgeted Cap X, which only indicates what is going to be spent annually as opposed to what needs to be spent in the aggregate to fix all of the risk.

3. Failure to identify, quantify, and adjust for future condition related hits to the anticipated NOI/ROI being

used to value a CRE property will always result in an inflated sales price and/or assessed value, and the property taxes based thereon.

4. If the items are incurable, then an additional risk rate needs to be added to the going in cap rate.

5. If the items are curable, then that estimated corrective cost needs to be quantified, documented, and deducted as a lump sum from the value indication for either purchase or assessment purposes.

6. Discounting the cost of multi-year remedial projects to a Present Value is rarely appropriate.

7. For assessment purposes, the best practice is to proactively and routinely report all Raw and Budgeted Cap X estimates to the assessor and to fully support any requested cost-to-cure adjustments.