

External Obsolescence

Overview of Issues Addressed:

- What is external obsolescence?
- What are the obstacles in arguing external obsolescence?
- Can there be obsolescence in newly constructed and/or stabilized properties?
- What are the ways to measure external obsolescence?

Property Tax Valuation

$$\frac{\text{MARKET VALUE} + \text{TAX RATE}}{\text{PROPERTY TAX}} =$$

The focus of a property tax appeal is the correct market value of the subject real or personal property.

Property Tax Valuation

DEFINING MARKET VALUE

The amount in cash which an informed buyer and an informed seller, each acting without compulsion in an arm's length transaction, would pay as of the assessment date for real or personal property.

Property Tax Valuation

How to Measure Market Value – Approaches to Value

1. Sales Comparison Approach
2. Income Capitalization Approach
3. Cost Approach

Property Tax Valuation

- The Cost Approach Analysis:
 - Determine replacement (reproduction) cost new (RCN)
 - Measure and deduct for all three forms of depreciation
 - Physical Deterioration (wear and tear)
 - Functional Obsolescence (depreciation from design of property)
 - External Obsolescence (depreciation from sources external to property itself – market conditions, new laws, change in feed stock supply, etc.)
 - Add value of land

Issue 1: What is External Obsolescence?

External Obsolescence is the loss in value of a property caused by factors external to the property?

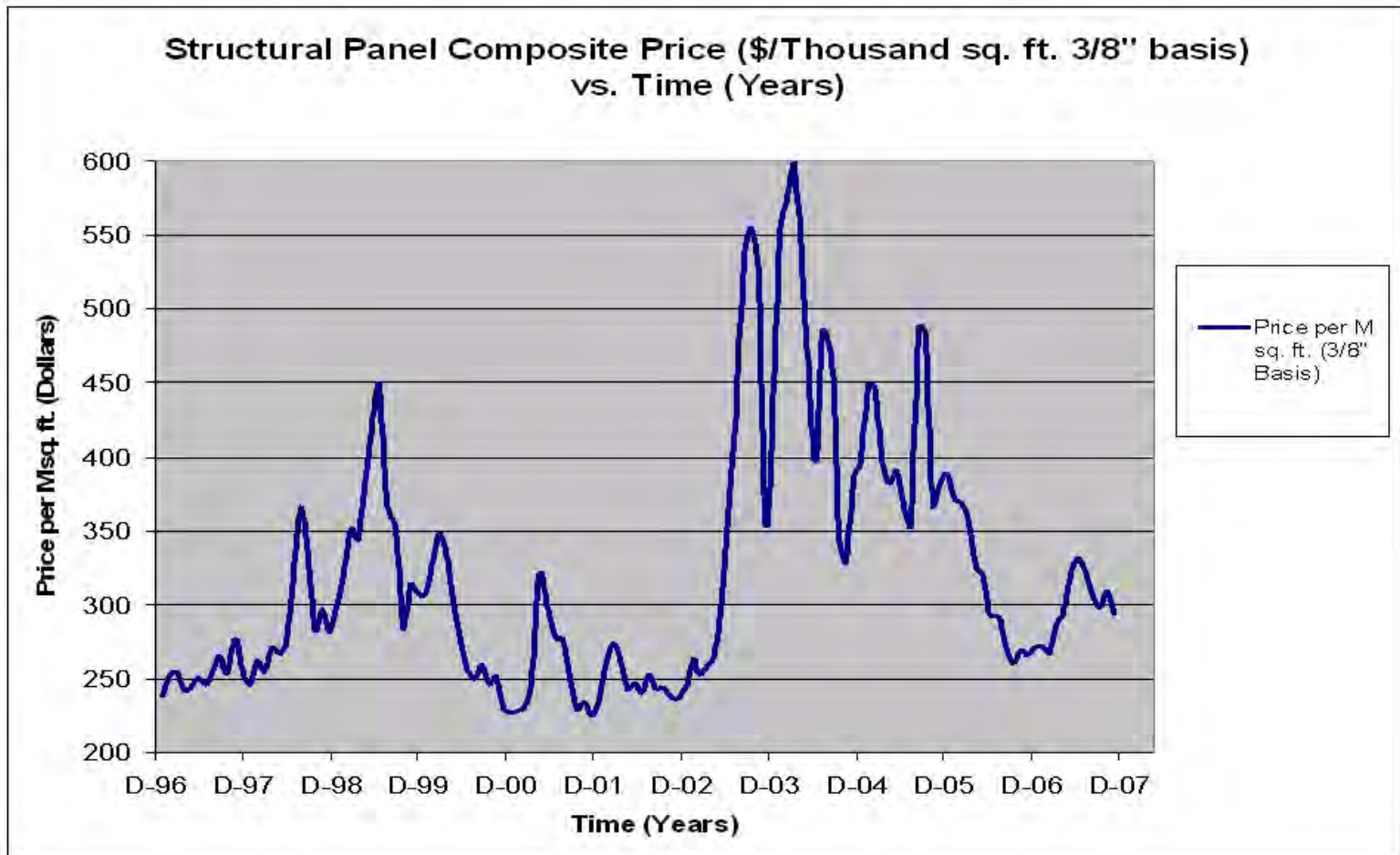
- Economics of the industry
- Availability of financing
- Loss of material and/or labor sources
- Passage of new legislation
- Changes in ordinances
- Increased cost of raw materials, labor or utilities
- Reduced demand for the product
- Increased competition

Source: Valuing Machinery and Equipment: The Fundamentals of Appraising Machinery and Technical Assets

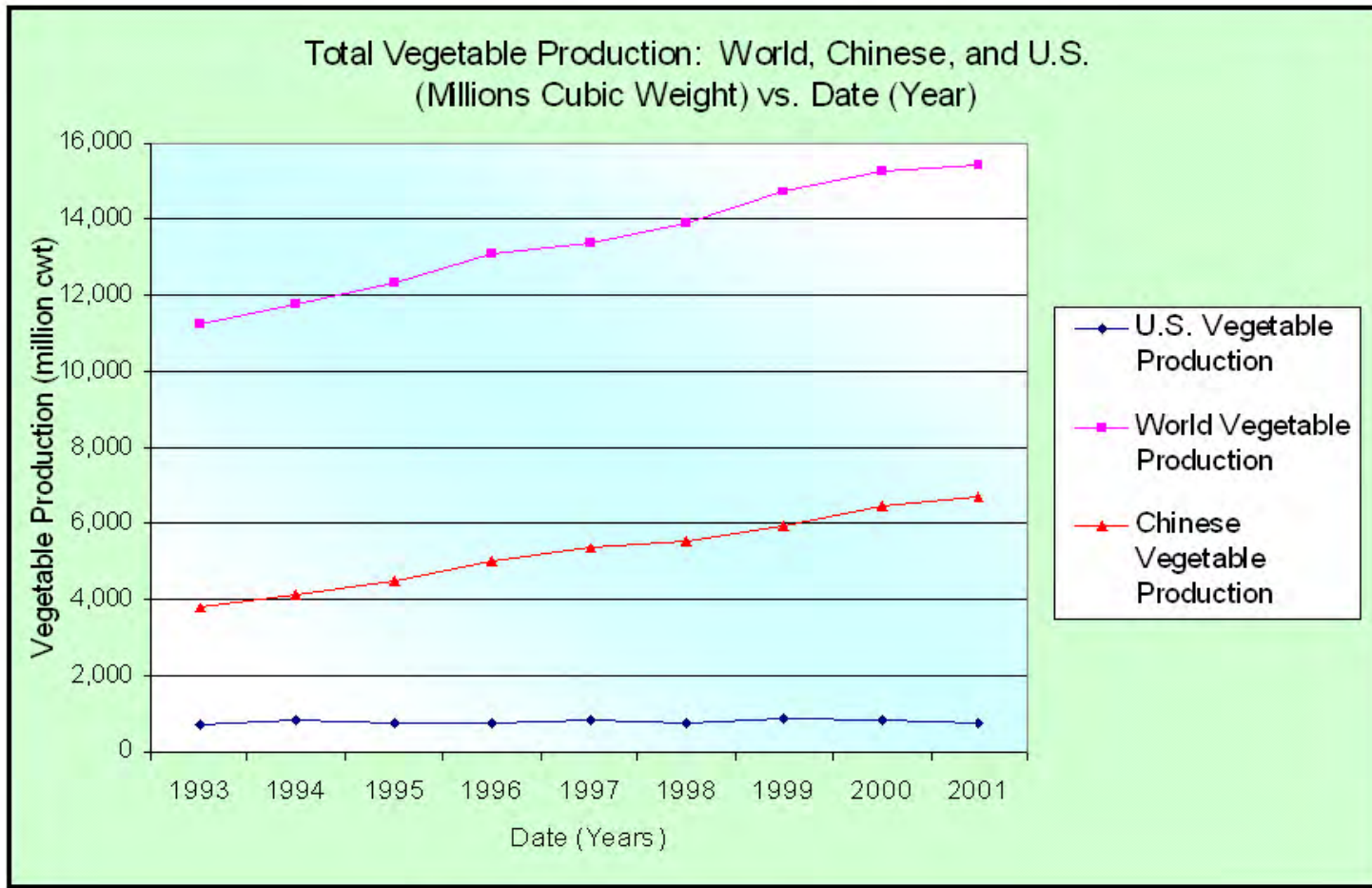
Issue 1: What is External Obsolescence?

What are some examples of external obsolescence due to changes in economic or market conditions?

Issue 1: What is External Obsolescence?



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Issue 1: What is External Obsolescence?

MONTHLY COMMERCIAL PROPERTY PRICE INDEX MOODY'S/REAL; NATIONAL, ALL PROPERTY AGGREGATE



December 2000 = 100

(Based on data through the end of May; Updated July 2010)

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Issue 1: What is External Obsolescence?

- Source Strategies, Inc. Texas Factbook 4Q 2009

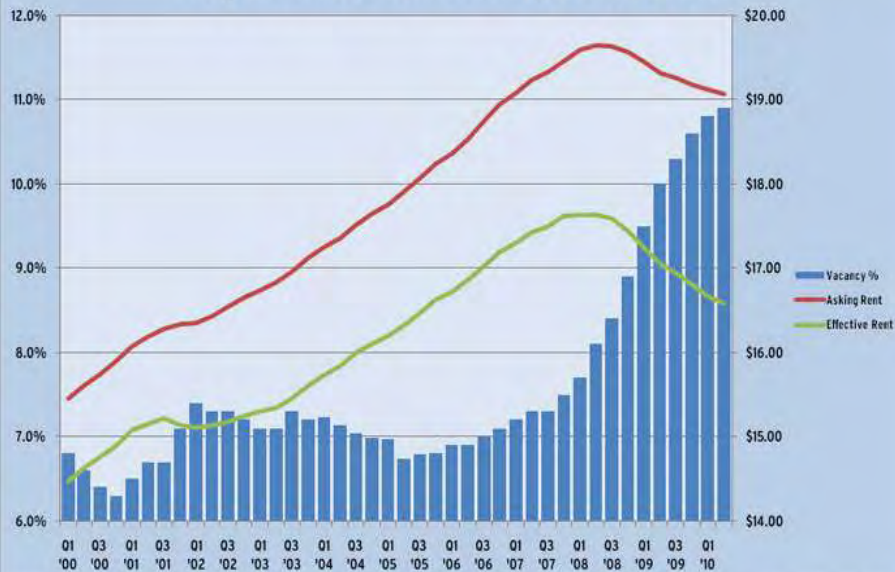


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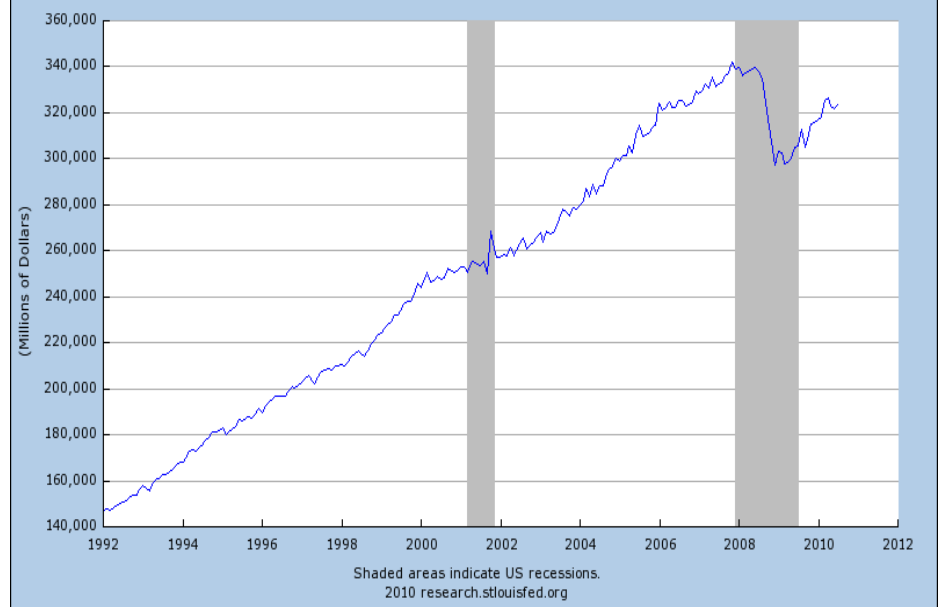
Issue 1: What is External Obsolescence?

Neighborhood and Community Center Trends



Source: Reis Inc. retailtrafficmag.com

Retail Sales: Total (Excluding Food Services) (RSXFS)
Source: U.S. Department of Commerce: Census Bureau



Shaded areas indicate US recessions.
2010 research.stlouisfed.org

Issue 2: What are the obstacles?

What arguments do assessors make when presented with a case for external obsolescence?

Issue 2: What are the obstacles?

- The property was recently built/purchased.
- The property is currently occupied and is being used as intended
- Income approach cannot be utilized
- The property is 100% leased
- Bad Management
- The comparable sales are distressed
- Can only use the Cost Approach
(replacement/ reproduction cost new less physical deterioration)

Issue 3: Newly Constructed/Stabilized

How can there be obsolescence when the property was recently constructed?

If the property is currently occupied and is being used as intended, how can there be external obsolescence?

Issue 3: Newly Constructed/Stabilized

- While there may not be depreciation from (1) physical deterioration or (2) functional obsolescence, there can still be (3) external obsolescence from a number of sources
- If the income from the property (after a change in economic conditions) cannot support the cost of a new property – there is external obsolescence
- Look to the market – not the subject property for evidence of obsolescence

Issue 3: Newly Constructed/Stabilized

Financing is limited for the foreseeable future.
How can a lack of available financing help
someone reduce their taxes when they already
own their property?



Issue 3: Newly Constructed/Stabilized

- Limited financing effects capitalization rates.
 - Leverage has been reduced in the overall market resulting in an increase in capitalization rates.
 - Simply put in order to achieve the same return on investment a property must be purchased at a lower amount when there is less leverage.
 - The resulting effect on the entire market reduces the potential market value of all like situated properties.

Issue 4: Measuring External Obsolescence

- What are the methods used to measure external obsolescence?

Issue 4: Measuring External Obsolescence

- Appraisers use many techniques to measure external obsolescence, some examples include:
 - ▣ Feasibility Rent Analysis
 - ▣ Net Income Shortfall (Capitalized Income Loss)
 - ▣ Inutility Calculations
 - ▣ Margin Squeeze Analysis
 - ▣ Market Extraction from Sale (all forms of depreciation)

Issue 4: Measuring External Obsolescence

- Retail
- Fee Simple vs. Leased Fee
 - Second Generation Market Rents
 - Feasibility rent



Issue 4: Measuring External Obsolescence

- Feasibility Rent Analysis:
 - Cost-Land & Building \$4,800,000
 - Initial Market Capitalization Rate 7.0%
 - Required Net Income 336,000
 - Market Vacancy (5%) / 0.95
 - Required Gross Income 353,684
 - Building Area (SF) / 33,483
 - Required Rent/SF \$10.56
 - Market Rent/SF \$5.00
 - Rent Shortfall/SF -\$5.56
- Indicated External Obsolescence 52.67%

Issue 4: Measuring External Obsolescence

- Net Income Shortfall – (Hotel Example):
 - New Courtyard (220 rooms) total cost + land = \$18,500,000
 - Project conceived in 2007 (high RevPar, low interest rates)
 - Market Cap Rate as of 1/1/10 = 10.83%
 - Achievable NOI (after mng, frn fees, reserves) = \$1,200,500
 - Income Value (before BV adjustment) = \$11,084,949
 - Difference between Cost and Income is External Obsolescence
- Whether cost or income approach is used, conclusion of Market Value is the same

Issue 4: Measuring External Obsolescence

MANUFACTURING PLANTS INUTILITY CALCULATION

HARDBOARD

Key	Value
A	65
B	140
X	0.7

$$\left[1 - \left(\frac{A}{B} \right)^X \right] \times 100 = 41.55\%$$

Key	Value
A	55
B	140
X	0.7

$$\left[1 - \left(\frac{A}{B} \right)^X \right] \times 100 = 48.00\%$$

Key	Value
A	76.1
B	140
X	0.7

$$\left[1 - \left(\frac{A}{B} \right)^X \right] \times 100 = 34.74\%$$

PARTICLEBOARD

Key	Value
A	82.7
B	140
X	0.7

$$\left[1 - \left(\frac{A}{B} \right)^X \right] \times 100 = 30.82\%$$

Key	Value
A	45
B	140
X	0.7

$$\left[1 - \left(\frac{A}{B} \right)^X \right] \times 100 = 54.82\%$$

Key	Value
A	55
B	140
X	0.7

$$\left[1 - \left(\frac{A}{B} \right)^X \right] \times 100 = 48.00\%$$

Issue 4: Measuring External Obsolescence

Margin Squeeze Analysis:

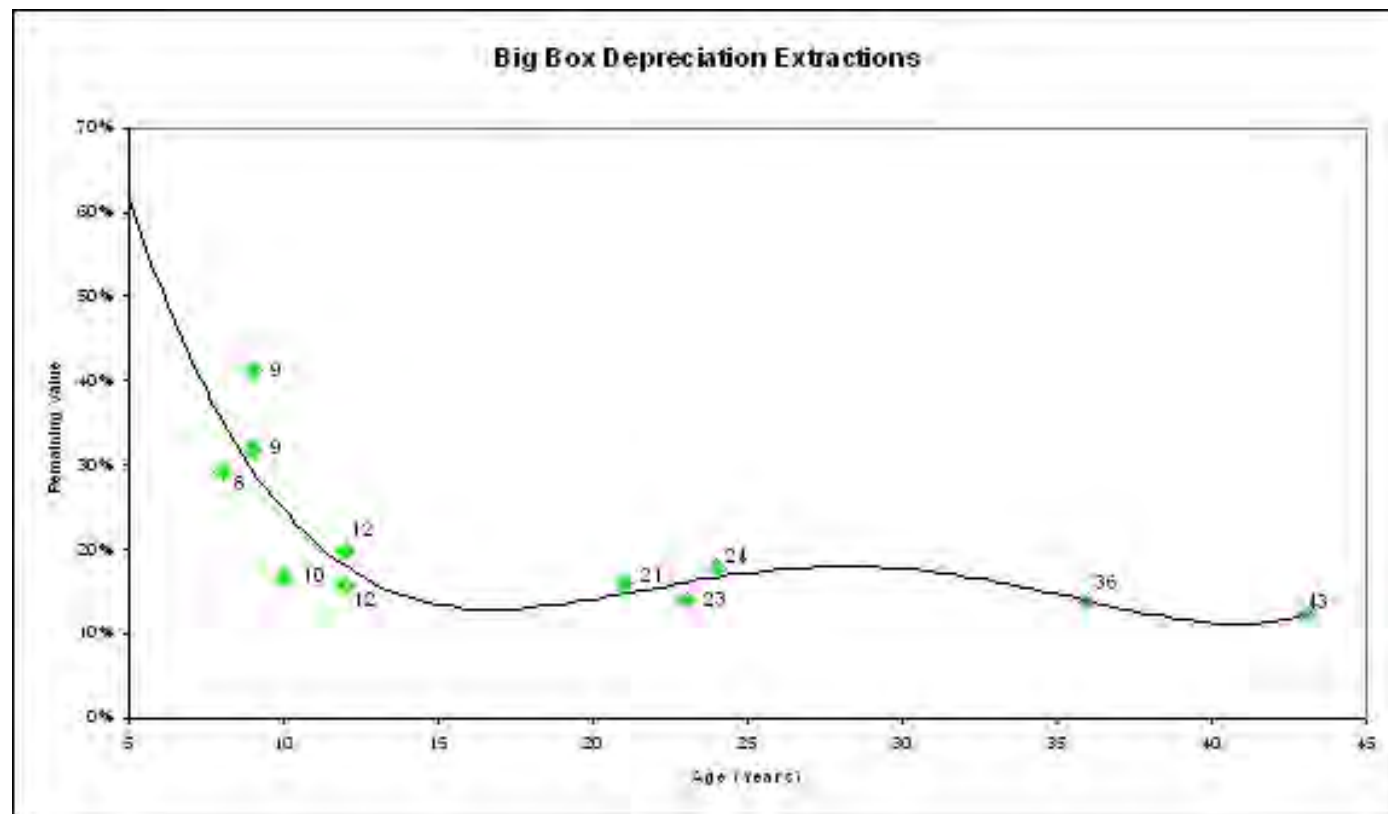
Gross Margin = [Sales price – Manuf. Cost]/Sales Price x 100

<u>Year</u>	<u>Sale Price</u> <u>Change/E.O.¹</u>	<u>Manuf. Costs</u>	<u>GM</u>	<u>%</u>
2004	122.13	73.74	40%	
2005	143.93	73.22	49%	+23%
2006	180.59	82.43	54%	+35%
2007	134.93	90.89	33%	- 18%
2008	111.15	93.24	16%	- 60%
2009	119.27	98.56	17%	- 58%

¹DOR Real Property Return Processing Procedures Manual, p. 17-6.

Issue 4: Measuring External Obsolescence

□ Market Extraction Approach:



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Concluding Remarks:

- David L. Canary, Garvey Schubert Barer, 121 SW Morrison Street, 11th Floor, Portland OR 97204 (503) 228-3939, dcanary@gsblaw.com
- J. Kieran Jennings, Siegel Siegel Johnson & Jennings, 25700 Science Park, Suite 210, Cleveland OH 44122 (216) 486-2848
kjennings@siegeltax.com
- Mark S. Hutcheson, Popp Gray & Hutcheson, 1301 South Mopac, Suite 430, Austin TX 78746 (512) 473-2661 mark.hutcheson@property-tax.com