

REAL ESTATE DAMAGES

Caused by Ownership Conditions

Further Applications of the DC Model

Prepared for the
Colorado Chapter
of the Appraisal Institute
September 18, 2009

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THE DC Model I - IV

The DC Model categorizes ten different conditions, both physical and nonphysical.

Conditions II-IV are nonphysical conditions, external to but still influencing the property.

- I. General: Property descriptive / market issues**
- II. Transactional: Unique sales or transfer issues**
- III. Distress/sociological: Human loss and tragedy**
- IV. Legal: Eminent domain, contract, tort, etc.**

THE DC Model V - X

Conditions V-X are physical, some connected with the site and its improvements, and some with surrounding physical attributes.

V. External: Neighborhood issues

VI. Building: Construction, equip/mechanical issues

VII. Soil/infrastructure: Soils, geotech, right-of-way

VIII. Environmental: Contamination, health, toxicity

IX. Conservation: Natural/cultural resource issues

X. Natural/climate: Natural disaster, weather issues

THE DC Model II Expanded

Items I-X concern the fee interest in the *whole* or a *divided* portion of the property.

Consider the position of an *undivided* interest—that can be attached to the fee interest. (After all, it is never the property itself that is appraised, it's always an *interest*.)

II. Transactional: Unique sales or transfer issues

Undivided/fractional interests

OWNERSHIP DAMAGE ANALYSIS

The valuation process rests on analysis of facts and circumstances for all forms of damage.

It is no different for ownership damages.

Analysis can be affected by *all* the facts related to the underlying property; the property's attributes, and:

- Other damage sources
- Financial aspects
- Owners' circumstances
- Legal structure



OWNERSHIP DAMAGE ANALYSIS

Questions:

Is the analytical process about real property valuation;
the underlying property, and
its physical, regulatory and financial environment?

Or, is it about business valuation;
the business of owning and operating real property?

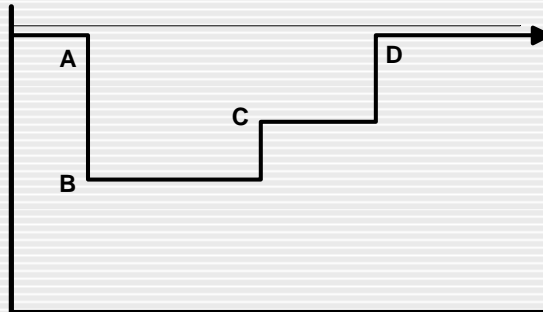
THE VALUATION PROCESS

The valuation methods for the undivided interest
“damage” all are ultimately based on two fundamental
questions:

What risk does the interest-holder face?

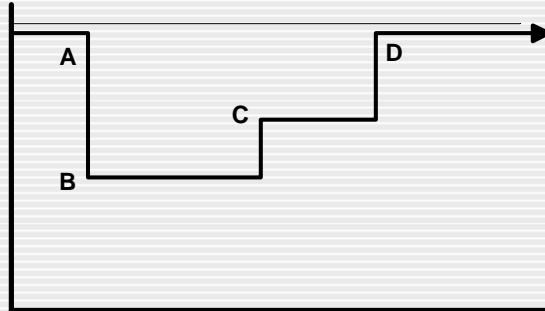
**How long will he or she have to wait before
realizing their pro rata share of the underlying
asset value?**

DAMAGE ECONOMICS



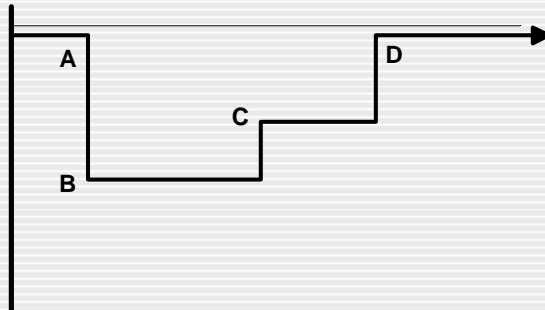
A. Unimpaired Value; related to Initial Intention:
Hold the property with others. What, me worry?
(Yes, there's a value issue, but who cares?
Phantom value impairment.)

DAMAGE ECONOMICS



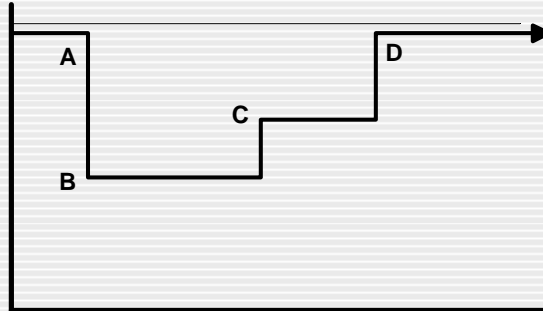
B. Need out: Changed circumstances, conflicts with co-owners, can't control the underlying properties. (Chickens come home to roost.)

DAMAGE ECONOMICS



C. Feasibility of cure: Can the interest afford to bring a partition action? Will the others oppose? Might they agree to sell? Will they buy out the interest? *What would the hypothetical buyer expect going in?*

DAMAGE ECONOMICS



D. Pro rata share: Buyout, sale of property and division of proceeds, or physical partition of property.

Returns to the value of the whole (the fee).

SCOPE OF THE PROBLEM

The Facts

The players:

All remain *except* the hypothetical buyer and seller of the subject interest.

Financing terms:

Balloon payment timing, Refi options, prepayment penalties.

Owner history & intentions re:

Property operations, other owners.

SCOPE OF THE PROBLEM

The Facts

Legal:

Agreements, other legal boundaries.

\$ Value of the interest:

Financial feasibility of forcing sale.

Value premise:

(e.g. transfer gift or held at death, internal buyout).

SCOPE OF THE PROBLEM

Real Estate Elements

Highest & best use:

Difference between market and owners' use.

Lease terms and conditions:

Nonmarket rent, term, turnover, TIs.

Other detrimental conditions:

Time and cost to cure.

External market conditions:

Value expected over time.

SCOPE OF THE PROBLEM

Business Elements

Management risk:

Decision-maker's competence

Hold period uncertainty

Control impairment:

Inability of the interest to control the property

Marketability (of the interest):

Is there an active market? Is it a security?

General undesirability

Extraordinary problem (postulating a lawsuit?)

ASSET (COST) APPROACH

Begins with fair market value (or other definition) of all assets and liabilities in which the interest has a share.

Typical cotenancy: + RP 100% fee interest
 + cash in accounts
 – mortgage loans
 – security deposit liability

 = net asset value

This typically gives a "control" value for the interest.

If the interest does control, or cannot be readily marketed, then it is discounted for these reasons.

MARKET APPROACH (SALES COMPARISON)

Idealized method (aka Holy Grail) is fractional interest transaction data involving similar properties.

Analysis similar to real property sales comparison, but much more uncertain and complex. Is this a workable process?

- How similar do the properties need to be?**
- How contemporaneous the transactions?**
- What really influences the discount??**

MARKET APPROACH (SALES COMPARISON)

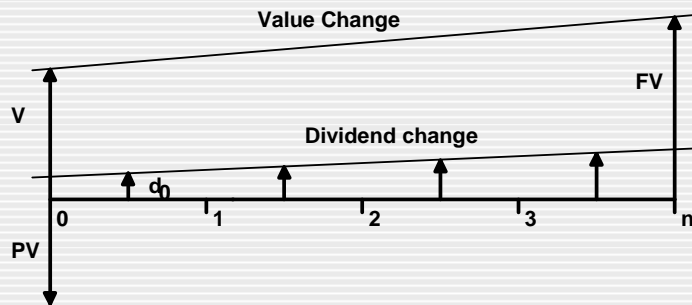
Other data sources:

- Discount surveys**
- Private partnership interests**
- Public partnership interests**
- Direct application of restricted stock study data**

INCOME APPROACH

Used to value interest directly, or With the asset approach, to develop the discount.

Basic analysis is a simple present value model:



INCOME APPROACH

Risk - Yield Rate Development

What are the risks that are incorporated in the overall and discount rates?

Interpret the market - just not obvious.

Not always hard data.

Risks added/exacerbated by the minority position and ownership structure.

INCOME APPROACH

Holding Period

*The fee holder can escape by selling,
but the minority holder cannot.*

What happens over time? How could value of the real property be maximized? Holding period based on facts & circumstances:

- Typical investor model (the “going-in” expectation)
- Lease rollover
- H&B use “hold for development”
- Needed upgrades
- Market conditions
- Balloon payment/refinancing

CONCLUSIONS

Valuation is dependent on an analysis of risk to the interest holder.

Determining risk and holding period relies on facts developed and understood as part of the real property appraisal discipline.

Equity valuation, ownership issues, and application of some market data are in the business valuation domain.

Is the valuation process similar to the process for real estate damages?

Do ownership damages belong on the DC Model?