



*presents*

# External Obsolescence in Property Tax

## Leveraging Market Conditions to Reduce Real and Business Personal Property Valuations

**A Live 110-Minute Teleconference/Webinar with Interactive Q&A**

**Today's panel features:**

Kieran Jennings, Partner, **Siegel Siegel Johnson & Jennings**, Cleveland, Ohio

Kevin Reilly, Senior Manager, Real Estate and Related Assets Group, **American Appraisal Associates**, Milwaukee, Wis.

Tony Barna, Principal, **Kelly-Rielly-Nell-Barna Associates Inc.**, Pittsburgh

John Dyslin, Member, Property Tax Services Group, **Ernst & Young**, Houston

Jason Chao, Senior Manager, **Ernst & Young**, Los Angeles

**Thursday, February 18, 2010**

The conference begins at:

**1 pm Eastern**

**12 pm Central**

**11 am Mountain**

**10 am Pacific**

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# **External Obsolescence in Property Tax Webinar**

**Feb. 18, 2010**

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# Today's Program

- Factors Leading To Economic Obsolescence, slides 3 through 16  
(*Kevin Reilly*)
- General Principles Of Economic Obsolescence, slides 17 through 31  
(*Tony Barna*)
- Relevant Accounting Guidance, slides 32 and 33 (*John Dyslin and Jason Chao*)
- Picking Your Battleground, slides 34 through 38 (*John Dyslin and Jason Chao*)
- Effectively Selling Your Company's EO Analysis, slides 39 through 48 (*Kieran Jennings*)

# **Factors Leading To External Obsolescence**

# What Is External Obsolescence? A Quick Refresher

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

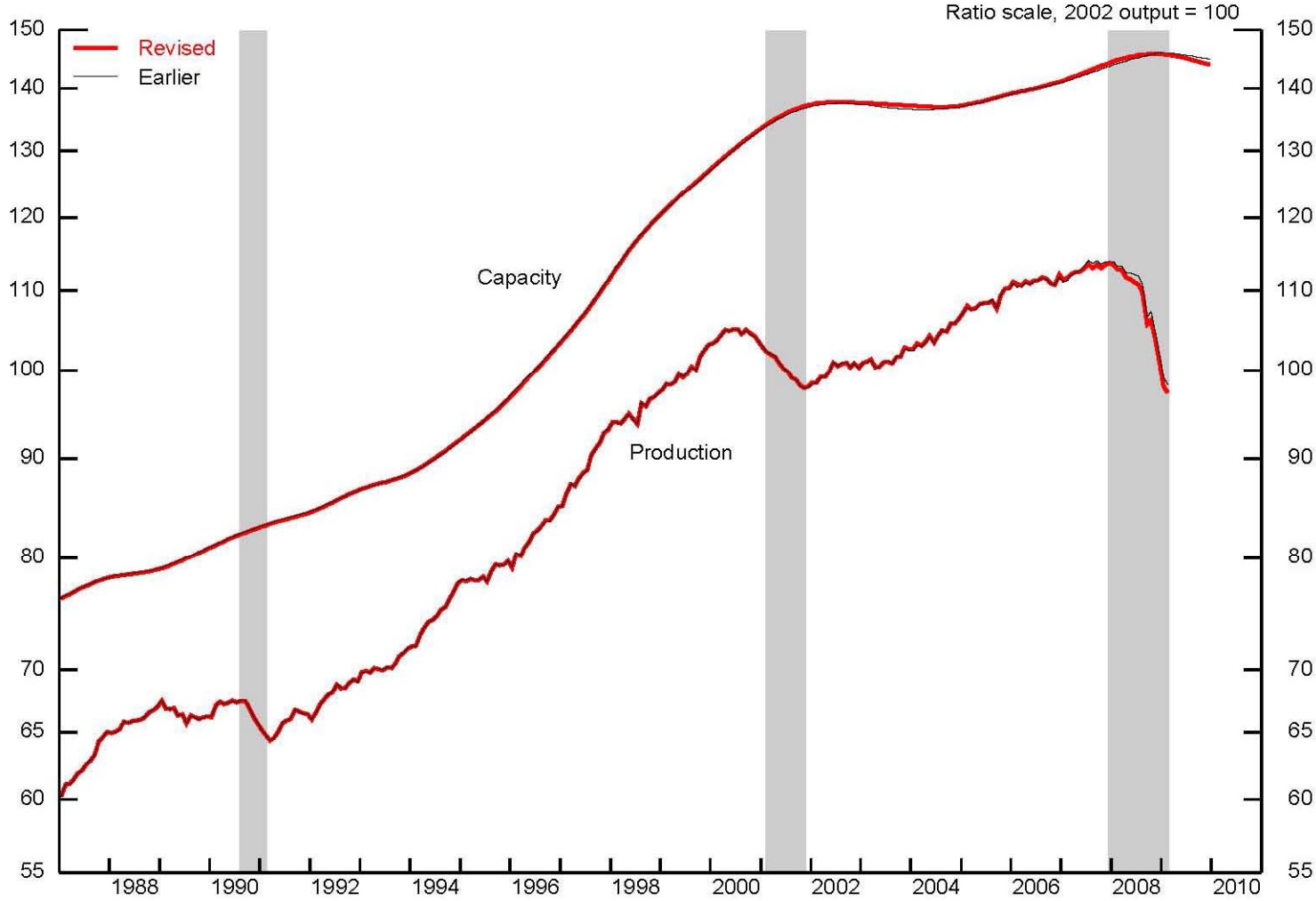
# External Obsolescence: Start To Finish

- Identifying
  - Is EO present, and why?
- Quantifying
  - What is causing EO helps dictate methods to quantify
- Explaining – “Telling a story”
  - Why is your property’s or asset’s value *reduced*

# The Current Economic Downturn And Its Effect On EO

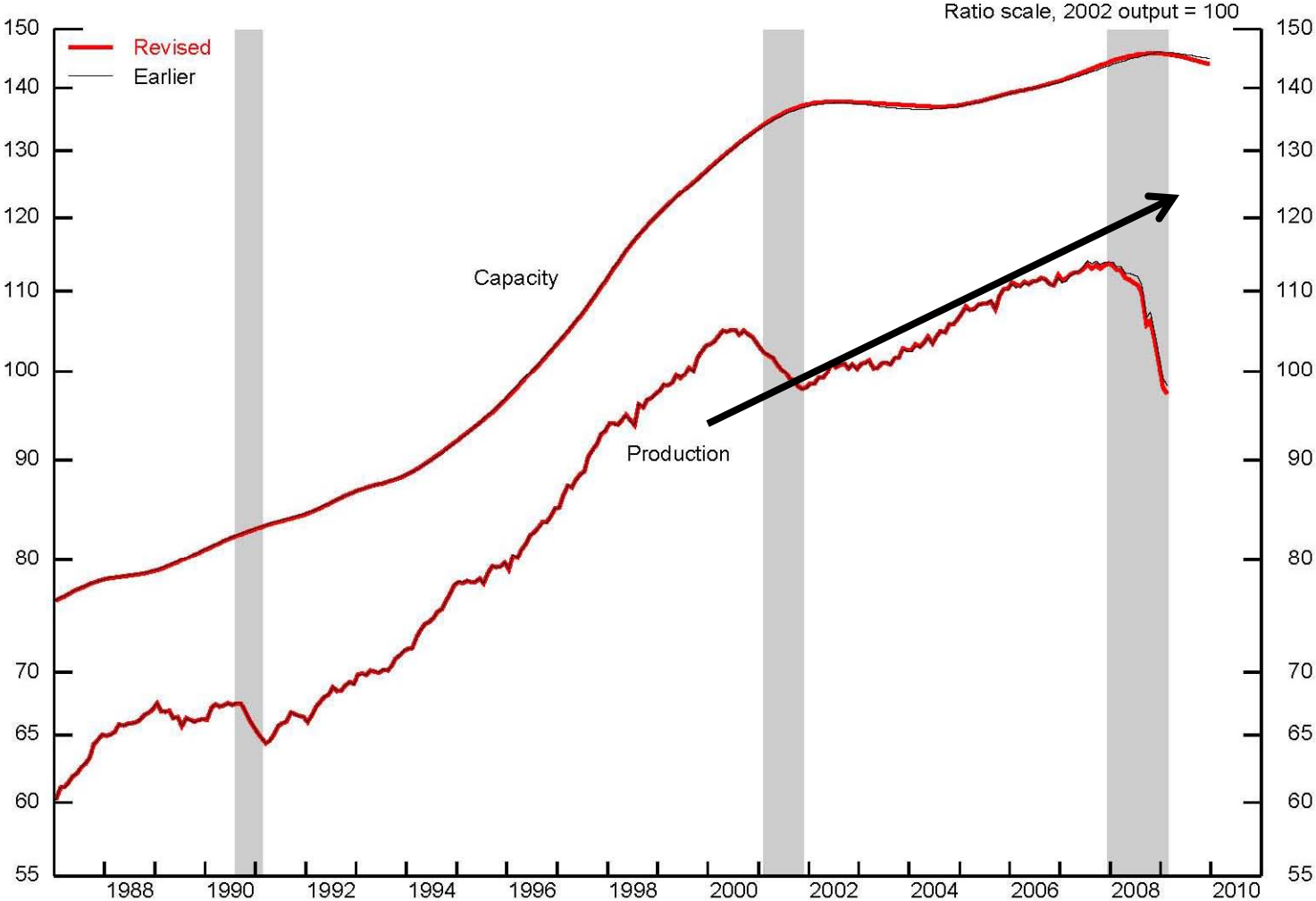
- Given the current economic environment, EO has become a BIG issue
- Conservative cash: Reductions in corporate spending
- Consistent or increasing capacity vs. reduced demand
- Obvious examples of EO:
  - Auto industry – Lack of demand
  - Real estate – Credit issues
  - Petrochemicals and refining – Overcapacity, competition
  - Power generation – Gross margin (lack of profitability)
- Many industries have been affected

# Manufacturing Industrial Production And Capacity



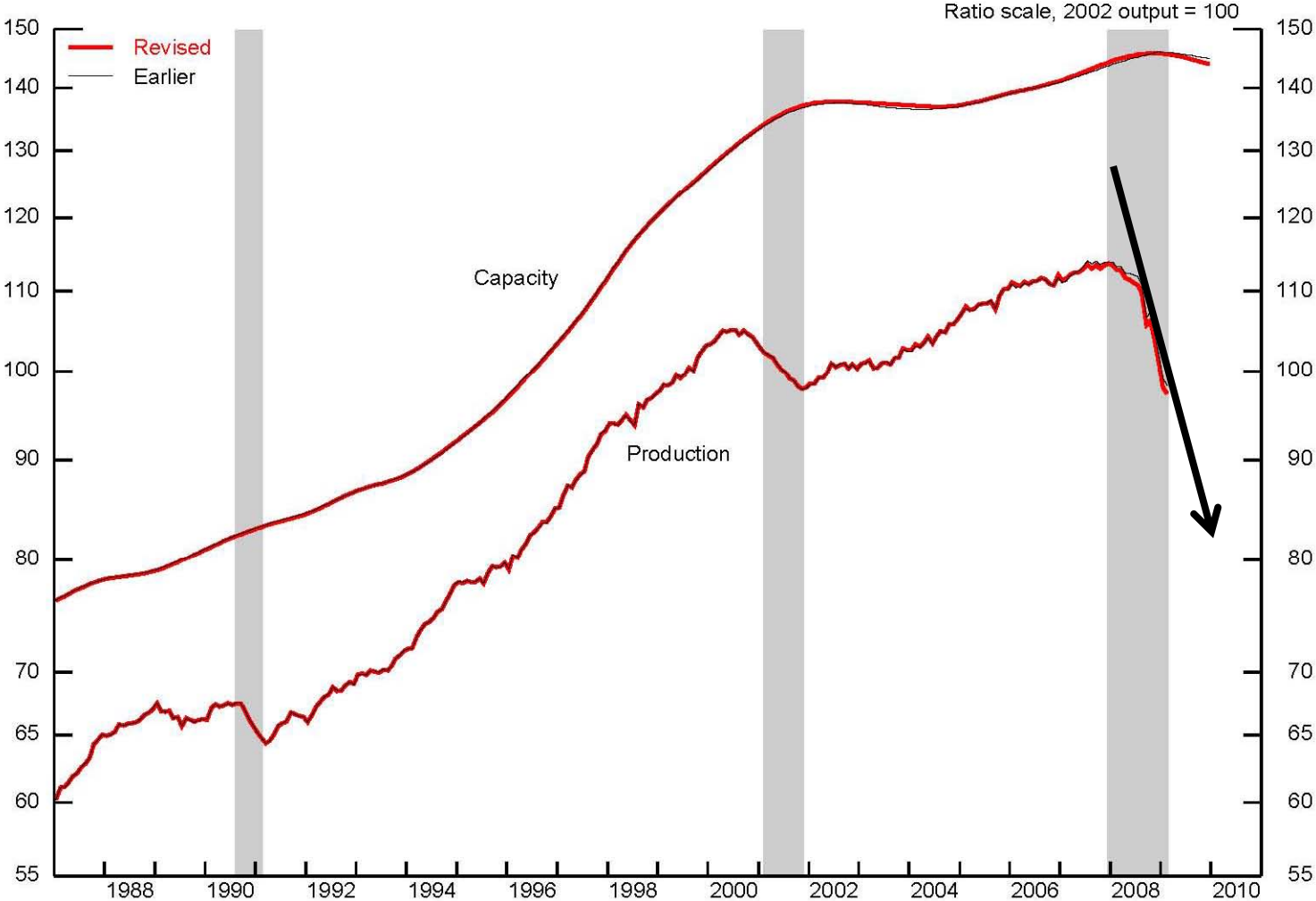
Source: Federal Reserve Statistical Release – G.17 (419) 2009 Annual Revision  
 Note: Manufacturing depicted in the chart above consists of those industries in the North American Industry Classification System (“NAICS”) definition of manufacturing.

# Manufacturing Industrial Production And Capacity (Cont.)



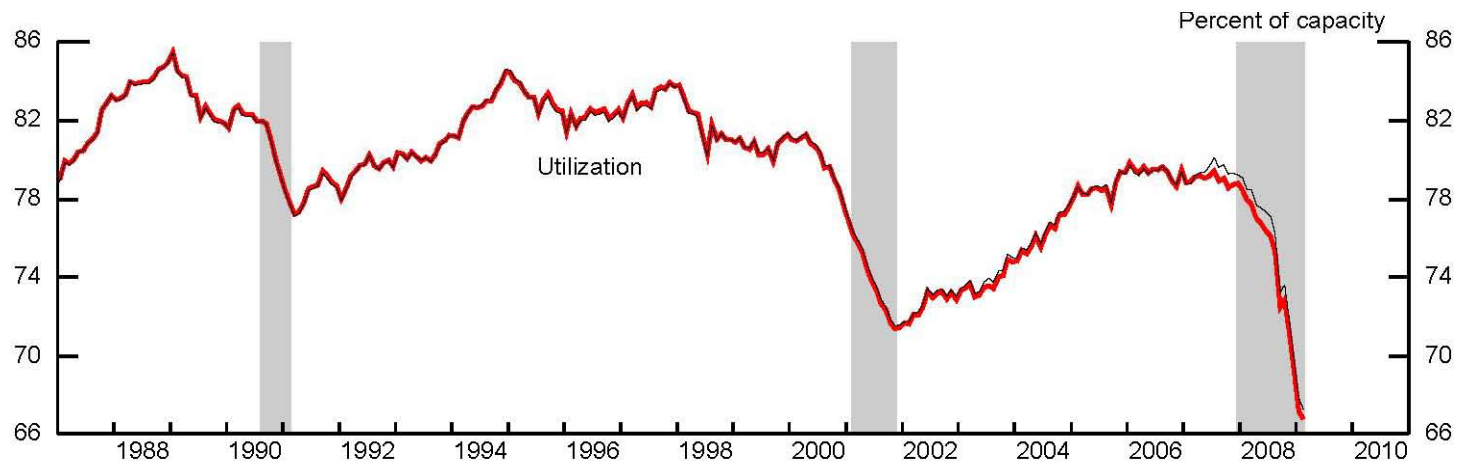
Source: Federal Reserve Statistical Release – G.17 (419) 2009 Annual Revision  
 Note: Manufacturing depicted in the chart above consists of those industries in the North American Industry Classification System (“NAICS”) definition of manufacturing.

# Manufacturing Industrial Production And Capacity (Cont.)



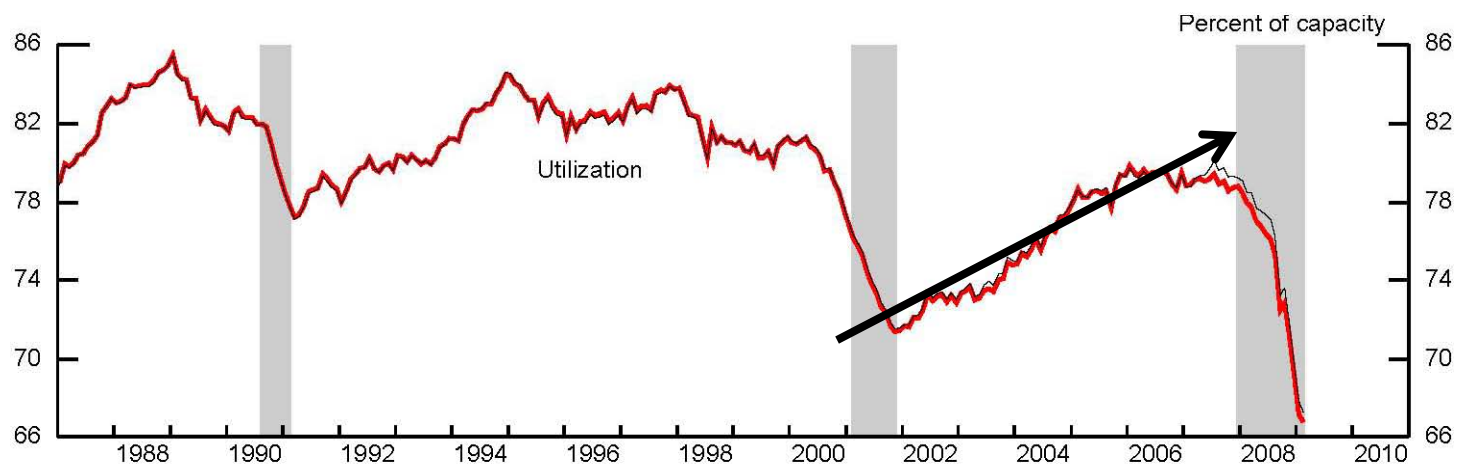
Source: Federal Reserve Stastical Release – G.17 (419) 2009 Annual Revision  
 Note: Manufacturing depicted in the chart above consists of those industries in the North American Industry Classification System (“NAICS”) definition of manufacturing.

# Manufacturing Industrial Utilization



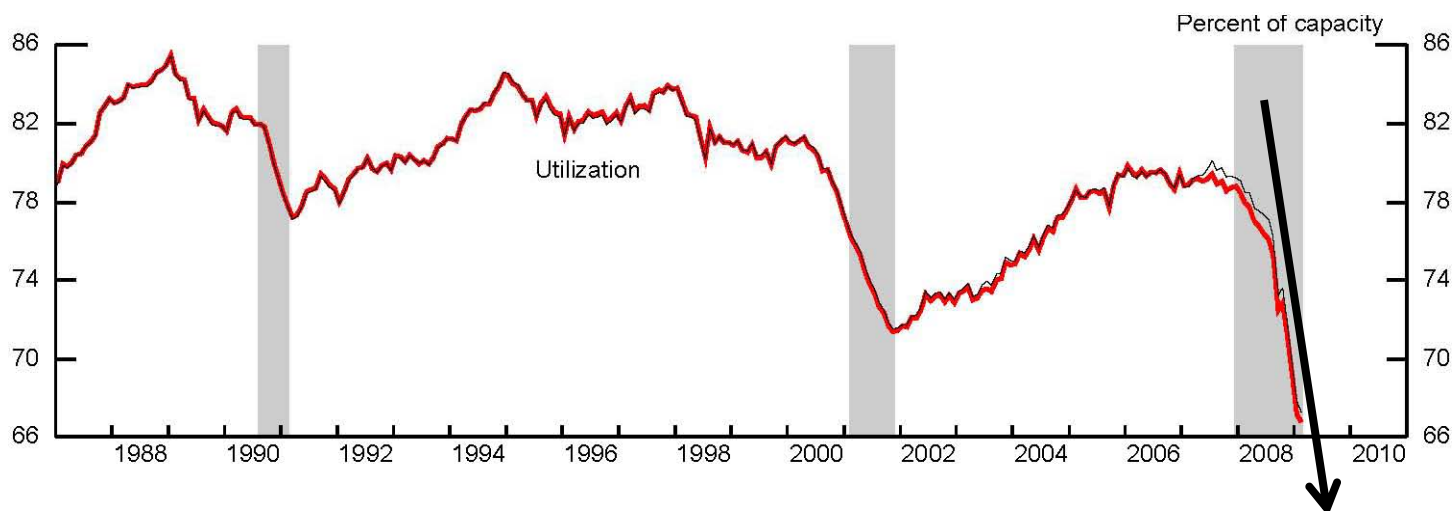
Source: Federal Reserve Statistical Release – G.17 (419) 2009 Annual Revision

## Manufacturing Industrial Utilization (Cont.)



Source: Federal Reserve Statistical Release – G.17 (419) 2009 Annual Revision

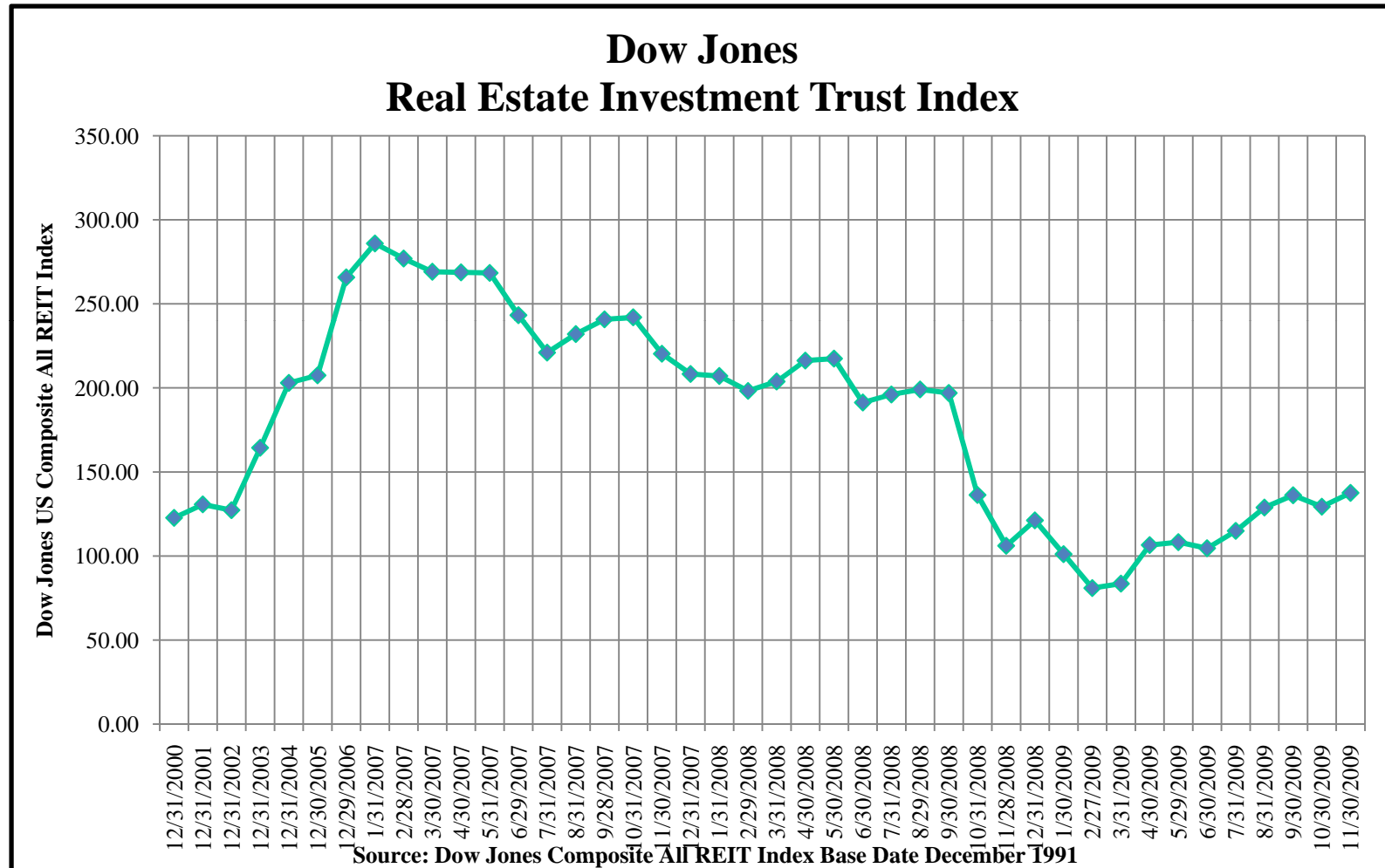
# Manufacturing Industrial Utilization (Cont.)



Source: Federal Reserve Statistical Release – G.17 (419) 2009 Annual Revision

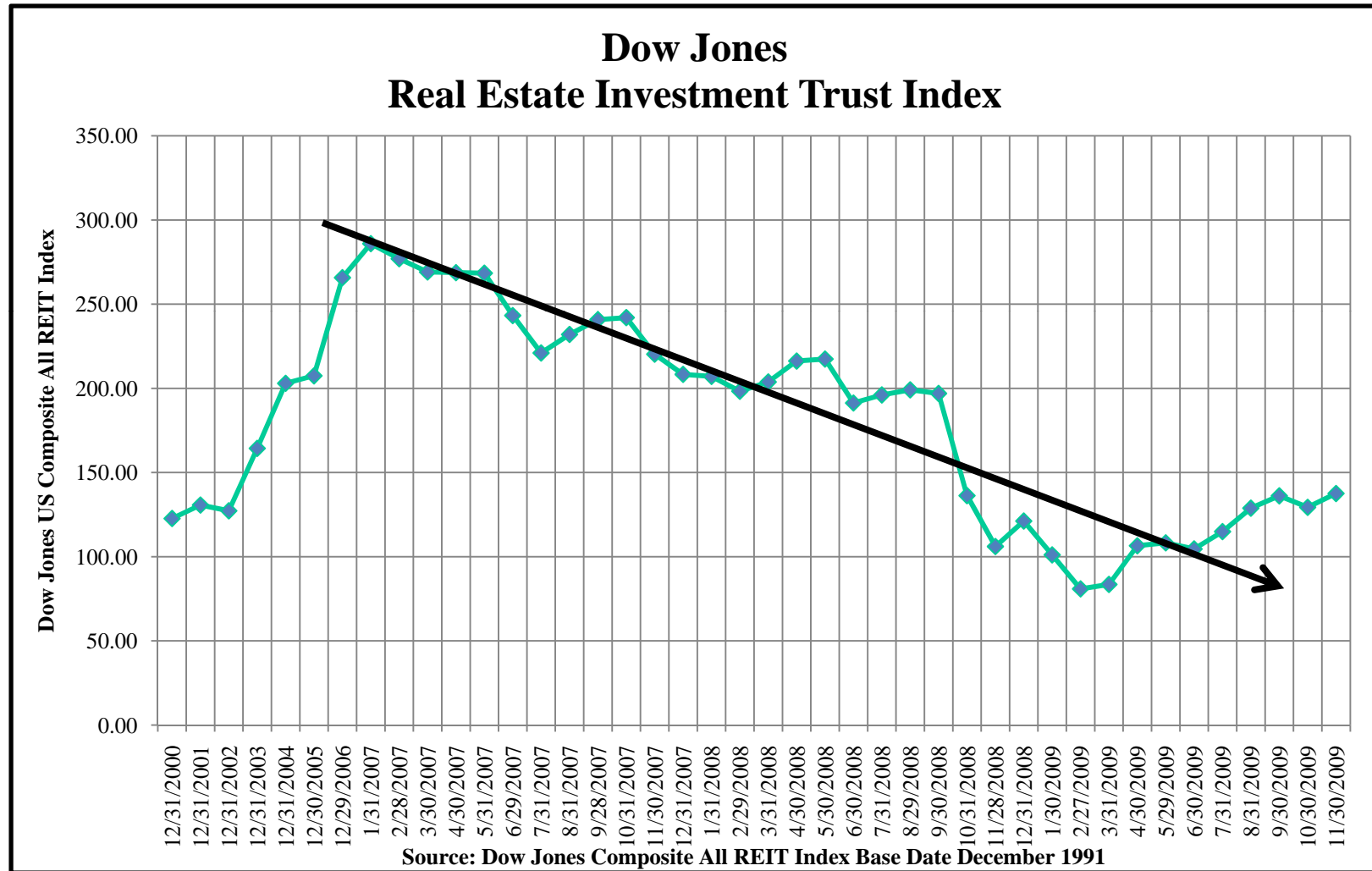
# General Trend In Commercial Real Estate Values

Current (Jan. 2010) values = Values in 2003 and 48% of 1/07 peak



# General Trend In Commercial Real Estate Values Cont.)

Current (Jan 2010) values = Values in 2003 and 48% of 1/07 peak



# Impact Of Governmental Mandates, Legislation

EO driven by special conditions in particular industry sectors

- Refining - Sulfur and emissions reduction
- Power generation - Deregulation
- Carbon cap and trade – Go or no go
- The cost of “going green”
  - Increased cost of doing business
  - Increased cost of electricity
  - More equipment, more people, more maintenance = More expense
  - Foreign competition in a global economy
    - Do other countries require similar emission standards (China, rest of Asia, etc.)?

# Techniques To Increase Your Success

## Explaining EO To The Other Side

- Use documented methods/methodology to quantify EO
  - Legal precedents
  - ASA Textbook: “Valuing Machinery and Equipment: The Fundamentals of Appraising Machinery and Technical Assets”
  - Independent outside sources (papers, articles, texts, etc.)
  
- Be able to support your results
  
- Things NOT to do
  - Make assumptions
  - Use techniques and methods that aren’t proven or that push the envelope

# **General Principles Of External Obsolescence**

# Overview: 3 Forms of Depreciation

- Depreciation = Obsolescence
- 1. Physical: Wear and tear
- 2. Functional: Deficiencies or super-adequacies in the structure
- 3. External: Outside of the property

# External Obsolescence

- Temporary or permanent impairment of the utility of a property due to negative influence(s) OUTSIDE the property
- Utility = Value
- Temporary: Oversupplied market
- Permanent: Proximity to an environmental disaster
- May result from adverse market conditions

# Characteristics

- It is NOT usually curable
- Both land and building are typically affected
- Usually has a market-wide impact on an entire class of properties, rather than just on a single property
- When location is cause (proximity to negative environmental factors), it may affect only one property

# Estimating External Obsolescence

- Sales comparison approach: Market data analysis
- Income approach: Capitalization of income loss
- Cost approach: Allocation of market-extracted depreciation

# Market Data Analysis

- Paired sales
- Comparable A (no external obsolescence) \$100/SF sale price
- Comparable B (external obsolescence) \$ 60/SF sale price
- \$40/SF loss in value from external obsolescence

# Capitalization Of Income Loss

- Comparable A rent = \$15/SF (no external obsolescence)
- Comparable B rent = \$10/SF (external obsolescence)
- \$5/SF rent loss/10% capitalization rate = \$50/SF loss in value

# Using Feasibility Rent

40,000 SF Office Building

Replacement Cost-Land & Building \$125.00/SF \$5,000,000

Market Capitalization Rate x 9.0%

Required Net Income 450,000

Expenses \$6.00/SF + 240,000

Effective Gross Income 690,000

Market Vacancy (5%) / 0.95

Required Gross Income 726,316

Building Area (SF) / 40,000

Required Rent/SF \$18.16

Market Rent/SF \$15.00

Rent Shortfall/SF -\$3.16

External Depreciation -17.4%

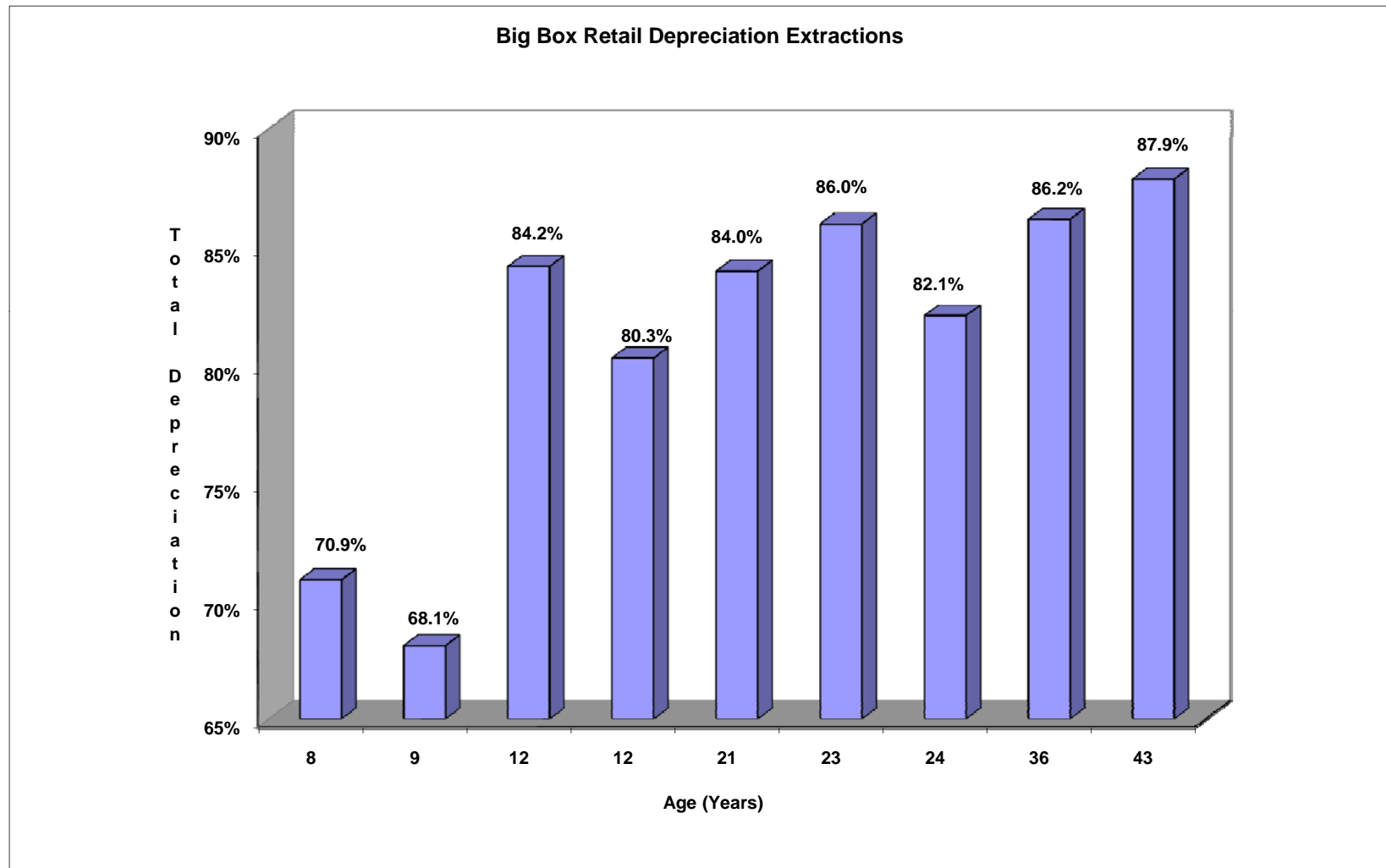
# Allocation Method

Sale Price	\$3,000,000
<u>Site Value</u>	<u>(2,000,000)</u>
Improvements Value	1,000,000
Replacement Cost	\$3,250,000
<u>Improvements Value</u>	<u>(1,000,000)</u>
Total Depreciation	\$2,250,000 = 69% Cost
Age of Improvements	9 Years
Physical Depreciation	6% (Marshall Valuation Service)
Functional Depreciation	0%
External Depreciation	63% (Allocation)

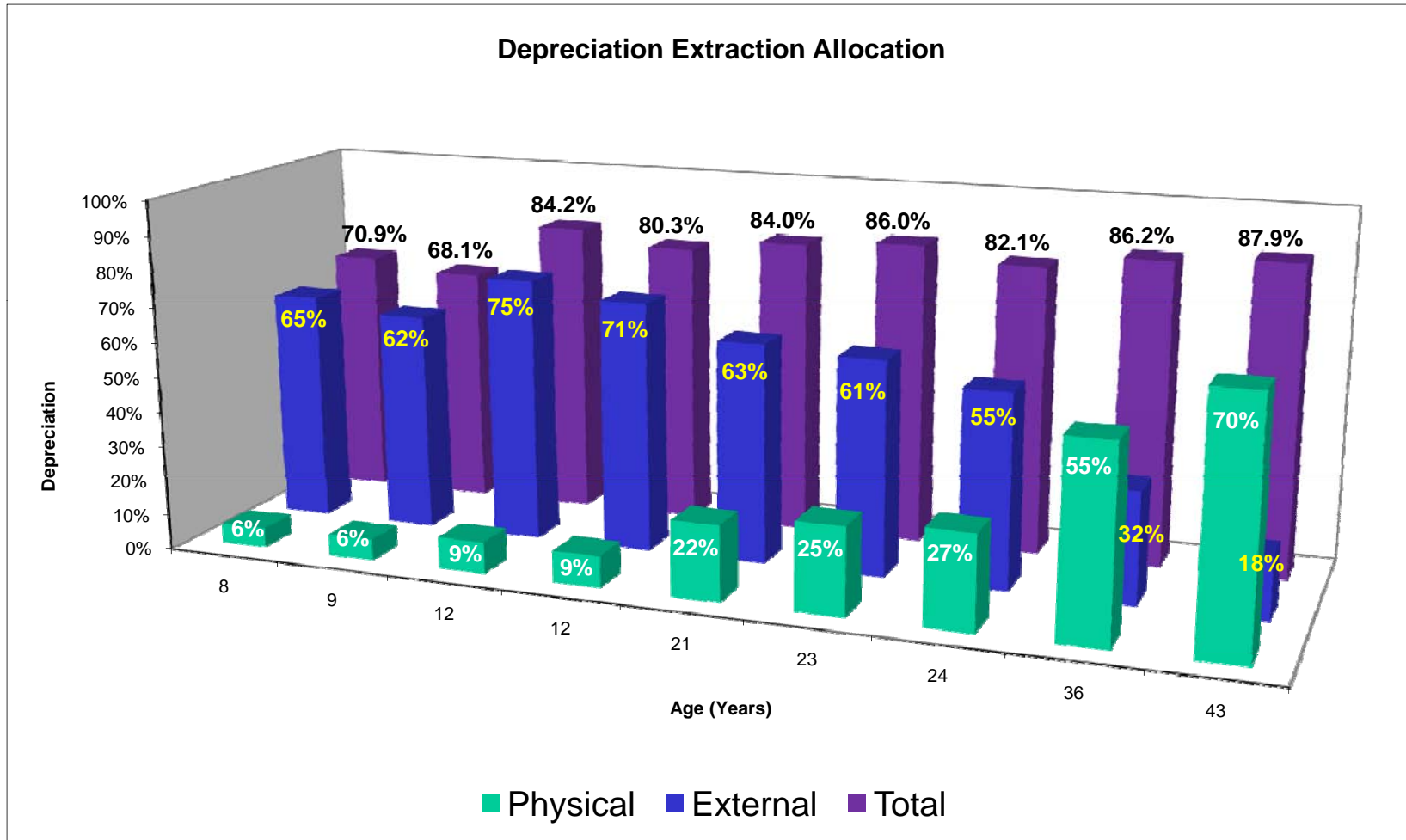
# Depreciation Extractions

- Analyzed the sales of nine “big box” retail properties
- All are situated in my market area
- Determined land value using comparable sales
- Calculated replacement cost using actual or cost service data
- Measured total depreciation as a % of replacement cost
- Know the age of the property
- Determined physical depreciation from Marshall Valuation tables
- Assumed no functional obsolescence
- Allocated external obsolescence from total

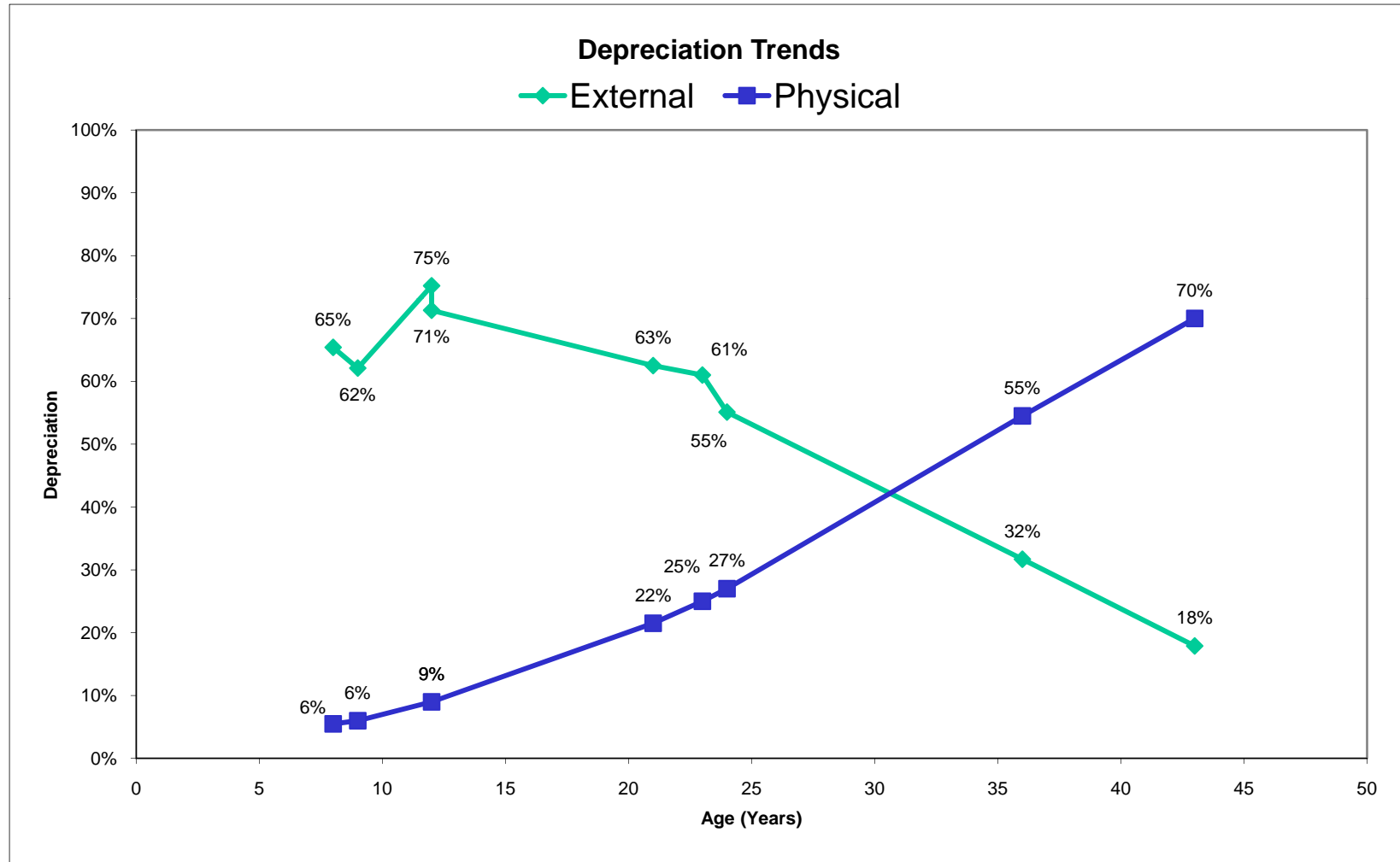
# Market Extraction Data



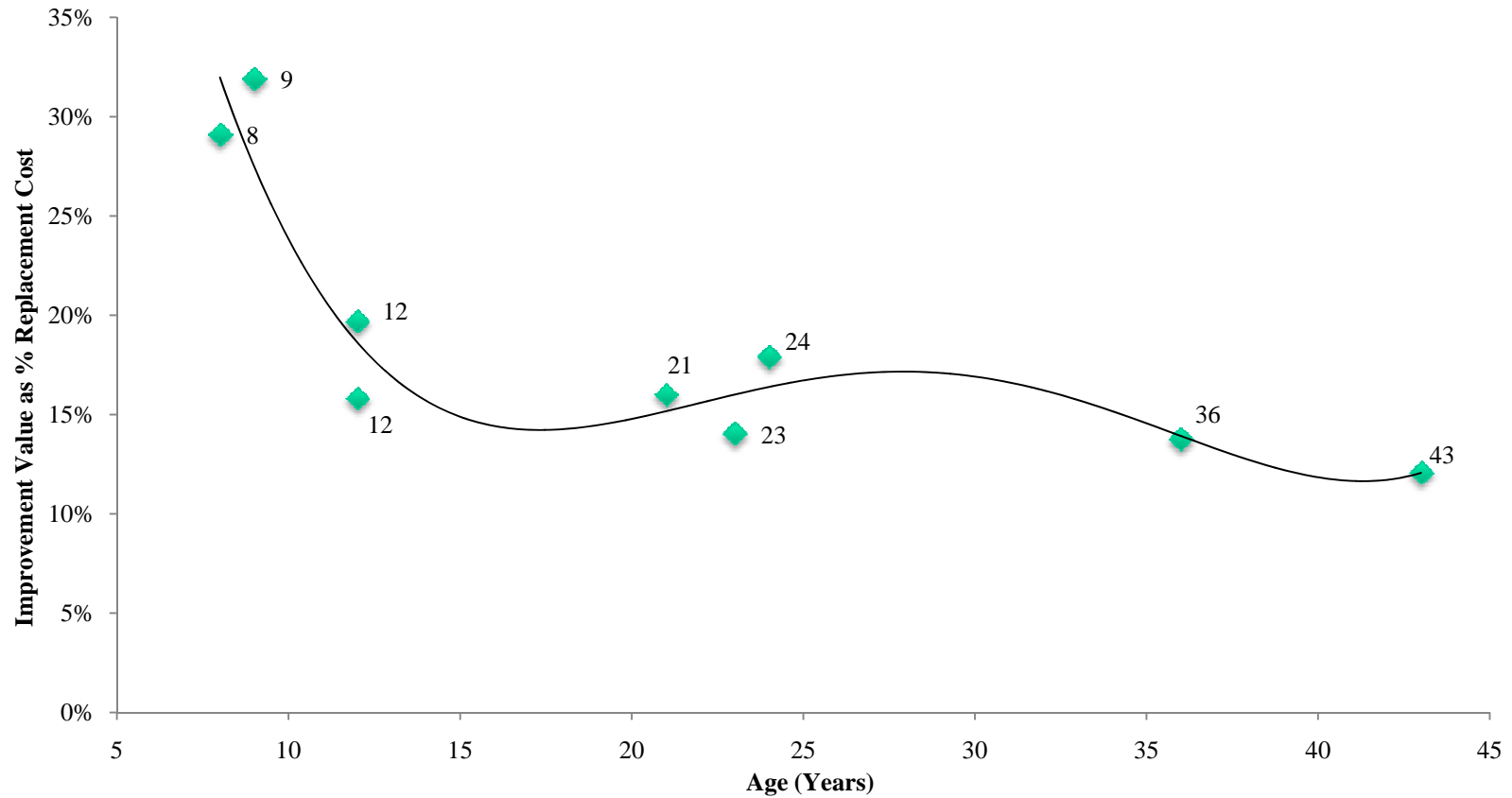
# Allocation



# External Vs. Physical



# Improvement Value



# Big Finish

- External obsolescence is an impairment of value from influence(s) outside the property
- Can be temporary or permanent
- Can be estimated by:
  - Market data analysis
  - Capitalization of income loss
  - Allocation of market extracted depreciation

# **Relevant Accounting Guidance**

# ASC 360/FAS 144 Considerations

- Potential accounting issues
- Proactive planning
- Reasons for no impairment

# Picking Your Battleground

# Assessor

- Current assessor mindset
- Key obstacles
- How to be successful
  - Proactive vs. traditional
  - Documentation wins

# Board Of Appeals

- Who is the BOA?
- Current BOA position
- How to be successful

# Litigation

- When to consider this option
- What states require legal counsel
- Current litigation environment

# Litigation (Cont.)

- How successful is this approach?
  - Cost/benefit analysis

# **Effectively Selling Your Company's EO Analysis**

# To Tell The Truth

- When establishing an argument for obsolescence, it is always best to not force the reality to conform with definitions
  - Measuring obsolescence is not the end it is the means to the end
  - Economic obsolescence, physical, functional obsolescence: Is it important to know where the obsolescence is found?

# Written And Oral Arguments



- Be concise
- Use examples
- Back up your arguments with market data
- There is no substitute for preparation

# Using Precedent To Win

- *Walgreen's v. City of Madison*
  - This case, billed as a fee simple v. leased fee argument, is a case which proves economic obsolescence. Not only does it proscribe that market rent must be used, it also shows the logical step for obsolescence is found by comparing rents in a given area and determining whether a property is economically feasible under market rents

# Design Changes

- Manufacturers, restaurateurs, elderly housing, retailers and other owners of real estate whose business drives design are particularly susceptible to changes in design. Those design changes can and should be used to help prove obsolescence

# It All Comes Back To Money

- Whether the obsolescence is physical, functional or economic, it all comes back to the dollar value of the impairment
- Rents, cost of construction, elimination of square footage on paper that is useless, costs to cure, and sales studies of second generation sales all help to prove obsolescence

# Renditions And Board Submissions

- Premature arguments
  - Complex arguments
  - Showing your hand
- Waiving an argument
  - In certain jurisdictions, an argument can be waived if it is not timely addressed
- Winning by default

# Know Your Opposition, Know The Counter-Arguments

- To whom are you presenting?
- Informal v. formal meeting
- Hearings
  - Are there third parties?
  - Boards
  - Press
  - Local presence

# Visual Aids

- Graphs and charts
- Pictures
- Too much of a good thing
  - Most people do not have a long attention span; if your argument is too complex, you will need to break it down into “bite-sized pieces”

# Technical Analysis Vs. Brevity

- K.I.S.S.
  - External obsolescence arguments typically are prepared after hours of painstaking data collection, well-thought-out analysis and thoughtful preparation. The person negotiating must remember he/she is there to convince the assessor or judge that a reduction in assessment is appropriate, not to prove the brilliance of the attorney/tax manager