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Weigh Anchor Inducements To Sink Property Tax Bills

Anchors weigh heavily in tax decisions.

Stephen Paul and Benjamin Blair

As the post-recession recovery for retail properties continues, local tax assessors are eager to increase shopping center tax assessments to their pre-recession highs or beyond. But regional and super-regional shopping centers are among the most complex types of real estate that assessors regularly value, and that complexity yields errors.

By failing to remove the value of an often-overlooked intangible asset, assessors are improperly attributing excess income to the real property, resulting in excessive tax assessments. This error stems from assessors incorrectly answering one of the most fundamental questions in property assessment: What property is being valued?

Too many assessors look at the income generated by a shopping center and conclude that the income is entirely attributable to the real estate. But the value of a shopping center's going concern is not equal to the market value of its real property. Unless the assessor makes an effort to extract the non-real-estate components, the value indications under the income and sales comparison approaches to value will capture not just the value of the real property, but also non-taxable personal and intangible property.

AGREEMENTS ARE INTANGIBLE

One major non-realty component of a shopping center's value is its operating agreements with anchor tenants.

Shopping centers depend on their anchor tenants for more than rent. Anchors typically make major advertising expenditures to draw customers to the property. As a result, customers ordinarily visit the mall with the initial purpose of shopping at the anchor retailer, and only then venturing out into the rest of the mall, which is typically the domain of more specialized retailers.

Shopping centers with better-quality anchors are able to draw more customers and charge higher rents to inline tenants. The presence of high-quality anchors also conveys stability, which attracts potential inline tenants. Conversely, when a mall loses one or more of its anchor tenants, inline tenants almost always follow the anchor, and the landlord must offer larger concessions to attract replacement tenants.

Beyond helping to attract and retain inline tenants, high-quality anchor tenants contribute indirectly to higher income generation for the shopping center. Because shopping centers often collect percentage rent, or rental income based in part on an inline tenant's retail sales, the long-term presence of an anchor that draws customers is vital to a mall's long-term financial success.

Shopping center developers typically offer significant inducements to attract and retain anchor tenants, and to convince those tenants to sign favorable long-term operating agreements. These inducements may take the form of cash, a preferred site, site improvements, or reduced expense recoveries, and may occur both upon the initial development of the shopping center and during redevelopment.

Whatever the form and timing, shopping centers have to subsidize the anchor's costs. The shopping center gets a return on this investment over the lifetime of the tenancy in the form of higher in-line rents.

Because the higher rental income from in-line tenants is, in part, a byproduct of the anchor operating agreements rather than a reflection of the real estate value alone, it is inappropriate to attribute the entire income stream to the real property. But when assessors use the total income of the shopping center's business in their calculations, they implicitly value the total assets of the business, rather than the real property alone.

PROPER ASSESSMENT TECHNIQUE

To properly value just the shopping center's real property, the income attributable to the favorable anchor operating agreements must be subtracted from the shopping center's total income prior to capitalization.

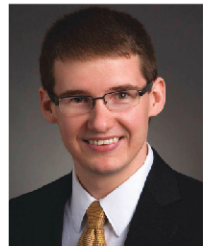
The calculation of the income attributable to anchor inducements is a two-step process. First, the appraiser must determine the value of the anchor inducements, accounting for both a return of the initial investment and a return on that investment that would be expected by developers in the market. There is no one-size-fits-all method of determining the amount needed to induce a particular anchor tenant. Every shopping center owner has its own method of determining how much it should pay in inducements to potential anchors given the location, size, age, design, and tenant distribution of the shopping center.

Whatever method is used to determine the value of the favorable contracts, it is important that appraisers select values that reflect inducements actually provided by market participants. For that reason, it is important that taxpayers contesting assessments select appraisers who have experience with shopping centers and who understand the dynamics of that industry.

(article continues on page 55)



Stephen Paul



Benjamin Blair

SCB: Who is buying, who is selling, and how high can pricing go?

Mousavi: Today's NNN buyer pool is the most diverse and dynamic our firm has ever witnessed. First time investors, family trusts, private investors and partnerships, foreign buyers (both private and institutional), public and private REITs, real estate funds, private equity groups, TICs, banks and insurance companies are all buying net leased properties. The seller profiles are also very diverse, however they all share the motivation to capitalize on this highly active market. We're transacting NNN properties for institutional owners that typically hold indefinitely, who are simply disposing of select non-core assets on an opportunistic basis due to favorable pricing. Yields for trophy NNN assets are now in historically low 3 percent range. Many experts believed that cap rates would never go below 5, then 4 percent. As we look to other highly active sectors, multifamily investments are also trading at ultra-low cap rates — some in the 2 percent range in markets like Manhattan and San Francisco. We are seeing many of these multifamily owners trading into retail NNN properties, pushing the cap rates lower. With the federal reserve set in motion to begin increasing interest rates, continued job market gains, and a slow but steady increase in wage growth, consumer confidence and spending, we do see a flattening out of the compression in cap rates for certain NNN properties and markets, particularly within the secondary and tertiary markets. We do see a low cap rate environment for some time, and within core markets and prized assets, ultra-low cap rates will continue. We see this as a peak-pricing type environment, and believe it is an opportune time for owners and developers to consider disposing of select assets within their portfolio, namely those with shorter lease terms and within non-core markets. **SCB**

ANCHOR INDUCEMENTS, continued from page 56

Once the assessor calculates the total return of and on the inducements, the second step in this process is to determine the income attributable to those inducements. To do this, the appraiser must amortize the total return over the term of a typical anchor agreement — generally 10 to 15 years — at a yield rate high enough to account for the fact that intangibles are the highest-risk components of a business enterprise.

The appraiser will then subtract the resulting figure from the going concern's net operating income, along with return of and on personal property and other non-real-estate expenses, such as start-up costs. The result will be the net income from the real property alone, which is the correct base for the income approach for property tax purposes.

For most retail properties, the largest expense after debt service is the property tax bill. Any reduction in the tax burden can drastically impact a property's profitability, and a reduction in property taxes passed through to tenants can itself be a method of attracting and retaining better-quality tenants. So as the retail market continues its slow recovery, proper treatment of anchor agreements may be a way to keep from drowning in excessive property taxes. **SCB**

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