Appraising Retail Properties in the "Amazon Jungle"

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Abstract

Changing buying patterns for retail goods and the impact of Amazon and other e-commerce have made retail perhaps the riskiest property type. Predicting which properties will "go dark" necessitates thorough market analysis. For owner-occupied properties, appraisers should ideally analyze the store's financial statements but at a minimum analyze historical revenues. In appraising hotels, nursing homes, convenience stores, and other property types, revenues are the primary measure of captured demand, and going concern appraisals are the accepted practice. The profession should be consistent in using the financial information of the going concern (at the store level) particularly in analyzing freestanding retail properties, and to the extent possible, all retail properties. This will improve the reliability of the highest and best use analysis and the forecast of durability of the current use. In this article, the "durability of the current use" relates to the likelihood of vacancy under the current highest and best use of the real estate, not the brand name occupying the space, with vacancy caused by deficiencies in location, functional aspects, or demand.

Introduction

Blockbuster had revenues of nearly $5 billion in 2000, with sales increasing at a compound growth rate of 13.9% in 1996–2000. With 51 million active movie rental accounts in the United States and Canada, one in six persons had a Blockbuster account. The 5,191 US stores allowed Blockbuster to achieve dominance by putting at least one store in virtually every small market.

Meanwhile, three-year-old Netflix saw promise in its online movie rental and mail delivery service, although streaming would not be available for seven more years. In 2000, Reed Hastings, the Netflix founder, offered to merge Netflix into Blockbuster at a price of $50 million,[1] as Netflix was losing money, with sales then in the $35 million range. Blockbuster CEO John Antioco declined the opportunity of a lifetime. Netflix grew to $11.7 billion in sales by 2017 and had market capitalization of $145 billion by October 2018. Blockbuster sales peaked in 2004 at $6.1 billion, but storm clouds were gathering, as Walmart and other discounters were taking market share by selling movies rather than renting. Blockbuster took a $1.5 billion impairment charge in 2004, and its sales and prospects deteriorated quickly. Netflix introduced streaming video in 2007, and Amazon had become a major competitor. Blockbuster filed for bankruptcy in 2010; in 2012 the last 300 corporate-owned stores were sold to Dish Network for $320 million, or about four cents on the dollar compared to the $8.4 billion Viacom paid for Blockbuster in 1994. Dish's $320 million investment proved to be essentially worthless. As of October 2018, only the Bend, Oregon, franchise remained.

Blockbuster's 10-K reports typically would begin with a market analysis showing total industry revenues and explaining how Blockbuster would continue to dominate the at-home video market. Obviously, the market analyses by Viacom in 1994, by John Antioco in 2000, and by Dish in 2012 were greatly flawed. They failed to recognize changes to the market—that streaming would become available was predictable. Over 5,000 Blockbuster stores closed over the space of a few years, including fee simple and leased fee properties. Of the hundreds of Blockbuster store appraisals done during its 2004–2010 decline, how many got the value right? Probably very few.

The Blockbuster story is not an isolated case. Sears dates to 1886 and was the Amazon of the

1. Mark Graser, "Epic Fail: How Blockbuster Could Have Owned Netflix," *Variety*, November 12, 2013.

early- to mid-twentieth century, as the company's sales were driven by a 500-page mail order catalogue rather than traditional stores. Sears sales topped $1 billion in 1945 (equivalent to $14 billion in 2018 dollars) and continued to lead US retail as it morphed into a department store model. By 2000, there were 863 department stores plus 1,200 specialty and smaller stores. The company was no longer the leading retailer when it was acquired by KMart in 2005 for $11 billion. The combined company (Sears Holdings Corporation) had 3,500 stores. Growth by Walmart, other retailers, and the increasing influence of e-commerce resulted in a Chapter 11 bankruptcy filing by Sears Holdings on October 15, 2018. Upon completion of recently announced store closings there will be approximately 700 KMart and Sears stores. The stock share price was $51 in mid-October 2013 and by mid-October 2018 it was just $0.40.

Other examples of retailers closing stores due to e-commerce competition include Payless Shoe Source, which closed 700 mostly mall-based stores in 2017, and Gymboree, which closed 300 clothing stores the same year. Drive through a retail corridor in most communities, and more examples can be found.

Daniel J. Radek's description of the retail market as bifurcated is complementary to the recommendations made in this article. He described the market's overall improvement as of the end of 2017 as follows: "This overall improvement belies a bifurcated market with better positioned and managed properties significantly outperforming other retail properties that are poorly located or undermanaged."[2]

E-commerce Is Growing, Spending Patterns Are Changing

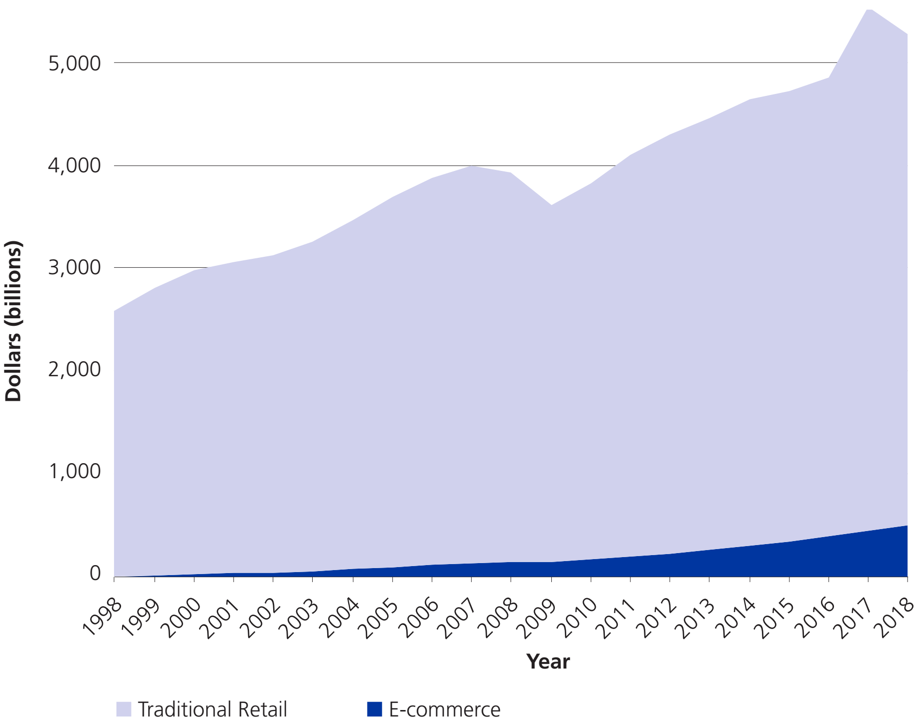
Retail real estate has become perhaps the riskiest property type. How much of this is due to e-commerce? Exhibit 1 graphs e-commerce against traditional store retail sales,[3] while Exhibit 2 shows that the impact of e-commerce on some retail goods is far greater than for other types of retail products. For some retail goods such as liquor, the impact of e-commerce is zero, while for GAFO retail businesses[4] the e-commerce penetration is now one out of every four dollars spent, as shown in Exhibit 2. Growing e-commerce in GAFO spending is impacting retail real estate throughout the United States.

The millennial generation, which includes some 71 million persons,[5] is entering strong earning years, while the baby boomers are spending less on retail as they age. The higher likelihood of millennials ordering products online will continue to grow e-commerce. A study by the International Council of Shopping Centers (ICSC) monitors spending patterns for millennials, and forecasts that their historical higher spending on health care and education, and diminished spending on clothing and footwear will become even more pronounced as they age.[6]

Amazon.com has grown from a small online bookstore, with first full-year sales of $16 million in 1996, to a behemoth offering most retail products, with 2017 sales of $178 billion. Amazon's revenues were 100% from e-commerce until its 2017 purchase of Whole Foods, a supermarket chain with $16 billion in sales. Amazon's growth (including international revenues) has been impressive:

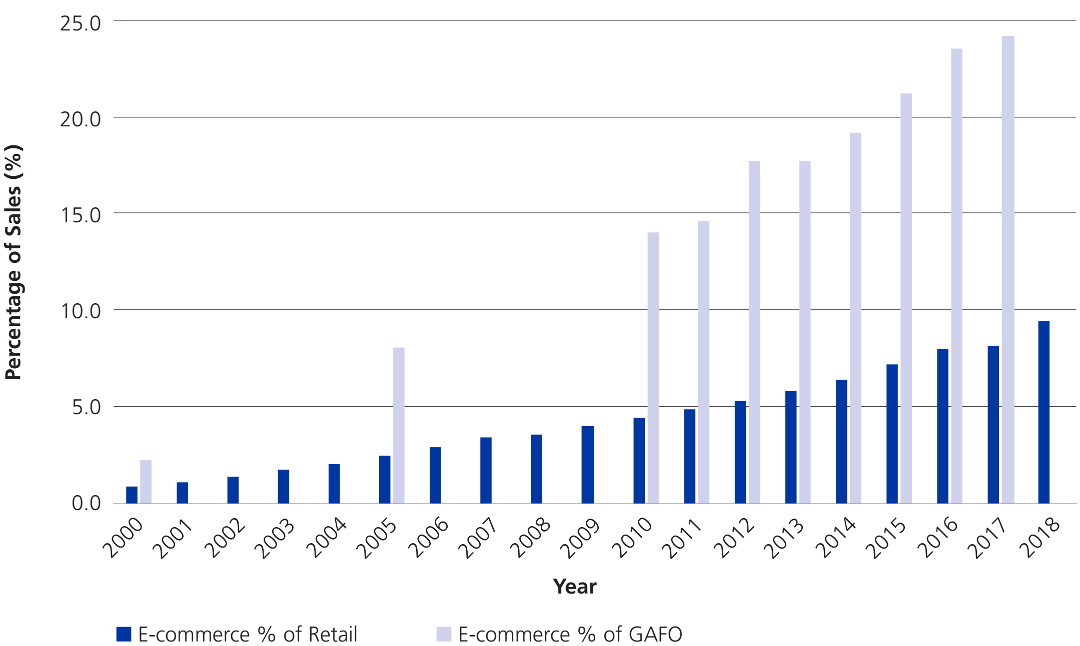
2. Daniel J. Radek, "Retail: A Bifurcated Market," *Fourth Quarter 2017 NCREIF Performance Report* (December 31, 2017), 14, available at http://bit.ly/NCREIF_Radek.
3. Data is from the US Census Bureau, which tracks both total retail spending and e-commerce. The authors assumed that traditional retail is the difference between total retail and e-commerce. Data for the first six months of 2018 has been annualized.
4. "GAFO" is a US Census Bureau acronym for the combination of the following retail business types: general merchandise (NAICS 452), apparel and accessories (NAICS 448), furniture and furnishings (NAICS 442), and other. The "other" group includes consumer electronics goods (NAICS 443), sporting goods (NAICS 451), and office supply stores (NAICS 4532). GAFO represents sales at stores that sell merchandise normally sold in department stores. See https://www.census.gov/retail/definitions.html.
5. Richard Fry, "Millennials Projected to Overtake Baby Boomers as America's Largest Generation," *Fact Tank*, Pew Research Center, Pewresearch.org, March 1, 2018. Pew Research identifies millennials as individuals born in 1981–1996. Data is from the US Census Bureau.
6. Jorge Perez, "Millennial Spending: Accounting for Global Differences," *ICSC Industry Highlights*, April 30, 2018.

Exhibit 1 E-commerce versus Traditional Retail Sales, 1998–2Q2018



Source: US Census Bureau

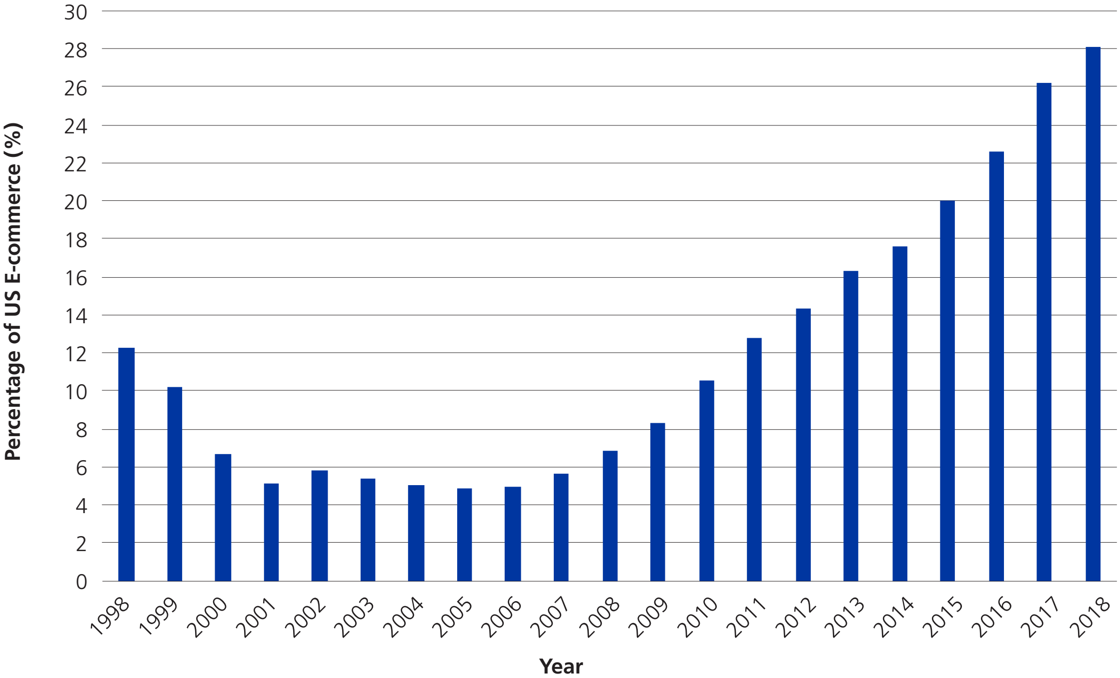
Exhibit 2 E-commerce as Percentage of US Retail Sales and GAFO*



* GAFO—general merchandise, apparel, furniture, and other retail goods.

Sources: *Market Analysis for Real Estate*, 2nd edition (236), US Census Bureau, International Council of Shopping Centers, and CBRE.

Exhibit 3 Amazon US Sales as Percentage of US E-commerce Sales



Sources: Amazon SEC filings and US Census Bureau.

- Revenues grew from $610 million in 1998 to $3.93 billion in 2002, a compound growth rate of 59%.
- Revenues were $10.7 billion by 2006, a 2002–2006 compound growth rate of 28%.
- Revenues were $34.2 billion by 2010, a 2006–2010 compound growth rate of 34%.
- Revenues were $89.0 billion by 2014, a 2010–2014 compound growth rate of 27%.
- Revenues were $177.9 billion by 2017, a 2014–2017 compound growth rate of 26%.

Exhibit 3 shows that Amazon's share of US e-commerce grew from 5% in 2004 to 28% for the first six months of 2018.[7]

In summary, e-commerce is driving US retail, and Amazon is driving e-commerce. Seismic changes are occurring in how money is spent, and e-commerce is now having substantial negative impact on retail stores for certain goods, with the GAFO group being hit especially hard. Appraisers, therefore, should perform thorough market analysis to forecast the future demand for all retail properties, whether leased fee, fee simple, freestanding, or multitenant.

You Can't Get the Value Right If You Get the Market Analysis Wrong

This article suggests that an analysis of the degree of favorability of the land and improvements to the current occupant, combined with an analysis of the financial success of that occupant, should be done early in the appraisal process. This analysis can determine if a re-leasing of the property and new tenant improvements will be necessary within the next several years. If there is a better alternate location for a business, or if the improvements lack functionality, the

7. The e-commerce data in the exhibit is from the US Census Bureau. Amazon's international revenues have been removed from total revenues. Amazon has changed its disclosure of international revenues over the years, and it does not disclose US revenues but contrasts international revenues with North American revenues. The authors have subtracted an estimated 5% of North American revenues to account for Canada and Mexico to make the comparison more meaningful. Press reports indicate that Amazon is approaching 50% of US e-commerce; however, this figure likely includes international sales, which were excluded in this article.

occupant is not likely to extend the lease. If the property is owner-occupied, the ownership may search for a better location and/or improvements. However, even if the location and improvements are ideal for the occupant, the property will likely "go dark" if the occupant's business is failing at that site.[8]

The preceding statements conflict with the 2009 *Appraisal Journal* article, "You Can't Get the Value Right If You Get the Rights Wrong," by David C. Lennhoff.[9] In that article, Lennhoff states that a fee simple appraisal must consider that "[t]he cost to build and worth to the initial owner or tenant well exceeds what the property would be able to command on the market for either lease or sale."[10] He further states that the appraisal of a fee simple interest must consider a sale of the property to a second-generation user. This article disagrees, as did writers of the "Letters to the Editor."

This article argues that only after a thorough market analysis, combined with a highest and best use analysis focused on the success of the current use, can an appraiser opine who the likely buyer will be and the value to that buyer.

As Lennhoff noted, one reason a discount is needed for the assumed sale for a second-generation use is because many owner-occupied properties are build-to-suit. *The Dictionary of Real Estate*, sixth edition, does not define *build-to-suit*, but it does define *first-generation space* and *special-purpose property*.

> **First-generation space.** A building or space designed to be functionally and economically efficient for the original tenant or a similar class of tenants over a period of time, during which the space retains its original utility and desirability.[11]

> **Special-purpose property.** A property with a unique physical design, special construction materials, or a layout that particularly adapts its utility to the use for which it was built; also called a *special-design property*.[12]

The definitions are similar, and the appraisal treatment of both logically should be similar. If a hotel is failing in its current use (with the financial statements being the primary evidence), then it is likely to sell, and the second-generation use might be a lower-level flag or a change to apartment use. Similarly, if a liquor store is failing (as evidenced by its financial statements), it is likely to vacate, and the next use is likely to be a different retail use.[13] The differences from the former use to a new use impact value, in part, due to the amount that must be invested in tenant improvements to change the use. Even when the use does not change, the vacant period plus some inevitable tenant improvements will negatively impact value whenever the occupant changes. A change from one fast food brand to another requires substantial new tenant improvements even though the change in use is subtle, since each fast food brand has specialized improvements.

If the hotel and the liquor store are both shown to be strong performers (as exhibited in their financial statements), then neither is likely to receive a change in use, and their appraisals should generally not assume one.[14] To assume otherwise violates the principle of highest and best use.

8. *Go dark* is defined as "to vacate retail space prior to a lease expiration. The space may remain vacant or 'dark' for an extended period of time." Appraisal Institute, *The Dictionary of Real Estate*, 6th ed. (Chicago: Appraisal Institute, 2015), s.v. "go dark."
9. David C. Lennhoff, "You Can't Get the Value Right If You Get the Rights Wrong," *The Appraisal Journal* (Winter 2009): 60–65.
10. Lennhoff, "You Can't Get the Value Right," 60.
11. *The Dictionary of Real Estate*, 6th ed., s.v. "first-generation space."
12. *The Dictionary of Real Estate*, 6th ed., s.v. "special purpose property."
13. If a liquor store goes dark due to failure of the business, and another liquor store operator chooses the same location, the new operator would have to conclude that the store failed either due to mismanagement or because the improvements are not functional or need renovations. Sometimes a change in use can be slight. If a steakhouse failed, the next use might be as an Italian restaurant, a slightly different use. There may not be adequate demand for a steakhouse while there may be demand for an Italian restaurant.
14. This statement is generally true for an as-is market value appraisal. There are circumstances where the assignment conditions may necessitate an extraordinary assumption that the property will be vacant at the time of sale. An interview of management may also indicate a desire to move a store to another location, even though the store is profitable in its current location. If a high-performing retail business desires to stay in its existing location, the operator no more wants to take on the costs and risks of a move than the property owner wants vacancy.

Using Market Analysis to Determine the Likelihood of Re-leasing the Property

Among the great contributions to appraisal theory in the past twenty-five are Stephen F. Fanning's texts on market analysis.[15] Much of appraisal practice is based on analysis of historic data, and Fanning's books have emphasized the importance of forward-looking analysis. The market analysis process is defined as having six steps in *Market Analysis for Real Estate*, second edition:[16]

1. What attributes does the subject property offer the market?
2. Who are the most likely users of these attributes?
3. Is the property use needed? (Demand analysis)
4. What is the competition? (Supply analysis)
5. What is the condition of the market? (Comparison of supply and demand)
6. How much of this market can the subject property capture?

While *Market Analysis for Real Estate* is comprehensive, it does not resolve the debate from Lennhoff's article. Recommendations are made here to add to the scope of the market analysis for retail properties, so that the often-debated need for a go dark analysis can be accurately determined. In addition to the types of inferred analysis discussed in *Market Analysis for Real Estate*,[17] the following aspects should be part of the six-step process in valuation of retail properties.

1. What attributes does the subject property offer the market? Is the subject property the ideal location with the ideal improvements for the current occupant? If the property is a relatively recent build-to-suit, it is likely to be the ideal location with ideal improvements. In this case, it is highly unlikely that the occupant will leave unless the business is failing. If the improvements or location are not ideal for the occupant, then a highest and best use analysis considering other users should be undertaken. Discounting for re-leasing and tenant improvement costs are likely to be needed in this scenario. Appraisers should interview store management/ownership and ask if they intend to stay at this location for the foreseeable future. If the highest and best use analysis is for a use similar to the current use, the cost of tenant improvements will be lower than if there is a significant change in use.

2. Who are the most likely users of these attributes? Is the current occupant an owner-occupant or a tenant? If a tenant, how long is the lease and how strong is the credit of the tenant? More importantly, how successful is the retail business at this location? If the business is not successful at this location, go dark and re-leasing are likely. A highest and best use analysis will determine the likely types of businesses for a second-generation use.

3. Is the property use needed? (Demand analysis) *Market Analysis for Real Estate* discusses inferred methods to provide necessary sales per square foot for retail properties. Obtaining the historical sales and trends for the subject store (actual captured demand) should be part of Step 3 but is postponed to Step 6.1 in *Market Analysis for Real Estate*, where it is recommended to analyze the "historical capture of the subject."[18] Just as occupancy and room rates by room type are analyzed for a hotel, the nature of the historic sales trends by department and the gross profit margins generated will tell much about the demand for the retail real estate.

15. Stephen Fanning, Terry Grissom, and Thomas Pearson, *Market Analysis for Valuation Appraisals* (Chicago: Appraisal Institute, 1994); Stephen Fanning, *Market Analysis for Real Estate* (Chicago: Appraisal Institute, 2005), and Stephen Fanning, *Market Analysis for Real Estate*, 2nd ed. (Chicago: Appraisal Institute, 2014).
16. Fanning, *Market Analysis for Real Estate*, 2nd ed., 14. The remainder of references to *Market Analysis for Real Estate* are to the second edition. The six-step market analysis process is also described in Appraisal Institute, *The Appraisal of Real Estate*, 14th ed. (Chicago: Appraisal Institute, 2013).
17. Fanning, *Market Analysis for Real Estate*, 2nd ed., 243, summarizes the six-step process for retail properties.
18. Fanning, *Market Analysis for Real Estate*, 2nd ed., 243. The text also states that historical performance should be analyzed for all property types (365).

4. What is the competition? (Supply analysis) The primary and secondary competitors should be identified. Competitors are identified not just in terms of square feet occupied, but more importantly in terms of annual sales (if this can be estimated), much like operating measures for competitive hotels, nursing homes, golf courses, and similar properties. E-commerce is often a significant competitor, which is accounted for as leakage as described in the *Market Analysis for Real Estate*. Any proposed development should also be thoroughly researched.

5. What is the condition of the market? (Comparing supply and demand)
6. How much of this market can the subject property capture?
Steps 5 and 6 in the analysis are related as they represent the conclusion of the market analysis. The total sales of the business are of great importance, since last-year sales are, by definition, captured demand after giving weight to existing competition. Market analysis should consider the sales trend and the impact of pending development, e-commerce, and other factors on future sales. If the location and improvements are ideal, with no superior alternative available, and the retail business is successful, then the likely buyer for an owner-occupied property is an investor in a sale-leaseback transaction or a buyer of the going concern (with the real estate being an integral part).

If the conclusion is that the likely buyer is an investor in a sale-leaseback transaction or a buyer of the real estate in combination with the business, some might first consider this as an investment value, however it is likely to be market value. Since a highest and best use analysis assumes a maximally productive use, the use that employs the subject's specialized improvements (which have value to the current user but are worthless to another user), and that involves no vacancy loss is very likely to be the highest and best use, making the buyer of the sale-leaseback transaction or buyer of the real estate in combination with the business as coequal probable buyers. Furthermore, just as there is a value loss when a property goes dark, a successful business takes a large risk and will likely incur tenant improvement and other costs by moving, making it unlikely for a successful user with ideal improvements to undertake a move.

Total Revenues: The Primary Measure of Captured Demand for Retail Properties

Location is strongly correlated with value for retail properties. Traffic counts, population density, position within or proximity to a retail corridor are all carefully analyzed by appraisers. Correlated with these important measures is the total revenue for the going concern. This is the accepted practice for the appraisal of hotels, nursing homes, assisted-living facilities, golf courses, bowling alleys, convenience stores, quarries, power plants, casinos, and many other properties. The prior year's total revenues for the going concern is generally adopted for the next year's revenues in the income approach, usually with only small adjustments made, making it the primary measure of captured demand for these property types.[19] With the income approach being so important for retail properties, the total revenues measure is also considered here as the best indicator of captured demand for restaurants, auto services, funeral homes, supermarkets, liquor stores, clothing stores, gift shops, salons, and other retail properties.

Appraisers should request financial statements (or revenues) for the business of owner-occupied retail properties because this is the best measure of captured demand. (It is more difficult to obtain revenues for leased properties). Other than in *Market Analysis for Real Estate*, how has the appraisal literature addressed obtaining historical income for the going concern? Both the Uniform Standards of Professional Appraisal Practice (USPAP), 2018–2019 edition, and *The Appraisal of Real Estate*, fourteenth edition, are vague on the topic, with both stating the importance of obtaining historical income information on a subject property. However, income to the property (rent), and income of the going concern that occupies the property (revenues of

19. While the adjustments to prior-year revenues are generally small, they can be large. For example, if significant added competition is in development, the impact on the subject's revenues may be substantial.

the business) are very different types of historical information, which neither USPAP nor *The Appraisal of Real Estate* distinguish.[20]

Users of appraisal services may be unaware that total revenue is the primary measure of demand and capture for retail property as well as for property types like hotels and nursing homes. Consequently, they might consider a request for financial information on retail businesses as out of bounds and irrelevant for a real estate appraisal. Yet, if a hotel owner refused to supply the detailed financials for a hotel appraisal, the appraiser would typically inform the client that the assignment is on hold until the necessary measurements of captured demand and profitability are supplied. This article recommends that greater consistency in appraisal practice is needed for all property types, particularly for the risky retail property type.

Appraisers should request and ideally receive the detailed retail store financial statements. This is true even for leased fee properties, since a business might have been current on rent for the past two years by drawing down a bank credit line, but next month the credit line is fully drawn, and the rent will not be paid. An appraiser receiving the financials would predict this failure, while an appraiser lacking financial information probably would not. Unless there is a percentage rent clause in the lease, tenants are less likely to share their financials than owner-occupants. Therefore, appraisers should make several brief visits to leased retail properties to survey store traffic, usage of the parking lot, and spending patterns. Such a market analysis at the subject site can result in a reasonable proxy of store performance, but it is clearly inferior to receiving store financial statements. Financial statements for owner-occupied stores are typically readily available to the store's bank when applying for a loan but are illogically not available for the appraisal process, since users of appraisal services consider them to not be applicable.

Data Sources

Though illogical, store financial statements continue to be unavailable in most cases, and particularly for leased stores. *Market Analysis for Real Estate* offers detailed methodologies to make estimates of demand and residual demand for a subject property and local submarket, based on projected sales for a retail business type in a defined market area, with likely sales for the submarket discounted for leakage to nearby properties outside the defined market area, and with discounts also applied for leakage to e-commerce.[21]

What level of rents as a percentage of sales are necessary for different types of retail businesses has a high degree of variability by type of retail. Exhibit 4 shows an exhibit from *Market Analysis for Real Estate*,[22] which used a 2008 survey that is no longer being updated. Occupancy cost ratios include rent and other property expenses except for utilities. This data can be used to test the reasonableness of the occupancy cost as a percentage of sales for a subject property, as these ratios have likely remained similar since 2008.

The CCIM Institute's Site to Do Business (stdb.com) can be used to estimate demand by type of retail goods, and Stores.org publishes an annual list of the top-100 US retailers, with the number of stores and annual sales shown. Using the size of the typical store, sales per square foot can be calculated, though caution is advised since for some companies, such as Walmart and Best Buy, e-commerce is now a large part of reported total sales.

Use of DealStats Data: Restaurant Example

The business valuation database DealStats[23] captures real estate information on businesses that sold, with data points for sales, square footage, rent, EBITDA, EBITDAR,[24] and other operating metrics for virtually all business types. Exhibit 5 is an exhibit from a 2017 restaurant valuation

20. Appraisal Standards Board, *Uniform Standards of Professional Appraisal Practice*, 2018–2019 ed. (Washington, DC: The Appraisal Foundation, 2018). The comment in Standards Rule 1-4(c) states "an appraiser must weigh historical information and trends" (Lines 538–539). *The Appraisal of Real Estate*, 14th ed., states, "the income and expense history of the subject property" should be analyzed (476).

21. Fanning, *Market Analysis for Real Estat*e, 2nd ed. Chapter 13, "Existing Shopping Center" (233–346) is a great resource.

22. Fanning, *Market Analysis for Real Estate*, 2nd ed., 303. This table was the product of a survey by the Urban Land Institute and the International Council of Shopping Centers.

23. DealStats includes financials on acquired companies in both the private and public sectors; it previously was known as Pratt's Stats; https://www.bvresources.com.

24. EBITDA = earnings before interest, taxes, depreciation, and amortization. When net rent is added, the result is EBITDAR.

Exhibit 4 Occupancy Cost Ratios for US Neighborhood Multitenant Retail Property Types

Tenant Classification	Median Total Charges Percentage of Sales (%) Regional Shopping Centers	Median Total Charges Percentage of Sales (%) Super Community Centers	Median Total Charges Percentage of Sales (%) Neighborhood Shopping Centers
General merchandise	3.01	6.86	7.57
Food	16.5	3.48	2.76
Food service	15.1	10.26	10.59
Clothing and accessories	13.0	9.70	7.43
Shoes	15.4	9.42	9.33
Home furnishings	14.2	11.62	NA
Home appliances and music	9.6	8.17	NA
Building material and hardware	NA	6.48	NA
Automobile	NA	6.39	6.54
Hobby and special interest	11.5	9.56	7.50
Gifts and specialty	12.8	14.00	14.37
Jewelry	12.2	6.31	8.21
Liquor	NA	6.81	NA
Drugs	NA	3.32	3.50
Other retail	15.1	10.65	10.69
Personal services	16.3	15.69	17.89
Offices (other than financial)	NA	9.38	11.81
Straight averages	12.9	8.7	9.1
Weighted* averages	5.0	6.5	5.7

*Weighted by median size of stores in ULI survey

Sources: *Market Analysis for Real Estate*, 2nd edition, 303. *Dollars and Cents of Shopping Centers/The Score* 2008. (Joint survey of Urban Land Institute and International Council of Shopping Centers.)

Exhibit 5 DealStats Full-Service Restaurant Market Data (SIC No. 5812)

Margins Analysis

	Net Sales ($)	Gross Profit ($)	Gross Profit/ Sales (%)	Rent ($)	Rent/ Sales (%)	Normalized Owner Comp (OC) ($)	Other Cash Op Exp. (OCE) ($)	OCE/ Sales (%)	Normalized Earnings (EBITDA) ($)	Normalized Earnings Margin (%)
Sample Size	91	91	91	91	91	91	91	91	91	91
First Quartile	827,852	522,301	61.7	56,082	5.4	73,867	277,545	35.8	58,635	5.8
Median	1,147,195	744,000	66.2	72,000	6.9	87,944	462,085	42.3	89,205	9.2
Third Quartile	1,549,179	999,393	70.0	118,428	8.9	95,984	635,606	46.6	160,012	12.5

Per Square Foot Analysis

	Net Sales ($)	SF	Sales/ SF ($)	Gross Profit ($)	GP/ SF ($)	Rent ($)	Rent/ SF ($)	Normalized Owner Comp ($)	OC/ SF ($)	Other Cash Op Exp. (OCE) ($)	OCE/ SF ($)	Normalized Earnings (EBITDA) ($)	EBITDA/ SF ($)
Sample Size	56	56	56	56	56	56	56	56	56	56	56	56	56
First Quartile	869,185	2,400	282	509,581	167	52,152	18	79,067	20	278,690	96	48,551	14
Median	1,137,953	3,200	344	752,846	209	72,000	24	87,759	25	475,063	130	88,027	33
Third Quartile	1,557,677	4,200	450	963,059	301	123,072	29	96,154	33	606,822	197	144,867	45

Valuation Analysis

	MVIC (Sale Price or SP) ($)	SP/ Sales	SP/Gr. Profit	SP/ EBITDA	EBITDA/ SP (%)	SP/SF ($)	(Net EBITDAR + OC) / Sales (%)	Net EBITDAR/ Sales (%)	EBITDA/ (Net EBITDAR + OC) (%)	EBITDA/ Net EBITDAR (%)	Net Rent/ Net EBITDAR (%)
Sample Size	91	91	91	91	91	56	91	91	91	91	91
First Quartile	197,500	0.23	0.33	2.25	44.5	70	19.1	11.6	30.6	47.2	28.4
Median	350,000	0.30	0.49	3.84	26.1	117	22.2	15.6	40.9	60.4	39.6
Third Quartile	607,500	0.42	0.64	4.99	20.0	152	26.1	18.6	50.0	70.8	51.4
Correlation		0.802	0.771	0.749	0.749	0.505					

webinar[25] that divided 262 restaurant sales into five subgroups (independent fast food, franchised fast food, limited service restaurants, bars, and nightclubs, and full-service restaurants). Since restaurants are a diverse group, independent pizzerias should not be compared with full-service restaurants. The example that follows shows how to use this data to support conclusions for a real estate appraisal. The data can also be used as support for a valuation of the going concern, though an example of a going concern valuation is beyond the scope of this article.

For example, assume that the subject is a 3,000-square-foot restaurant with annual sales of $1,050,000. If the only information available is the net sales, then the sales for the subject is $350 per square foot; this is in line with the DealStats median of $344 per square foot (Exhibit 5). If the business is in a more or less average cost area, the business should be near the median net EBITDAR margin of 15.6% of sales, which estimates $163,800 EBITDAR for the subject. The contract net rent is $35 per square foot, and the analysis of local restaurant rents suggests that this is at the high end for smaller full-service restaurants, with the local range at $25 to $35 per square foot. The net rent then is $35 × 3,000 square feet, or $105,000, which is 64.1% of net EBITDAR, leaving a combined 35.9% of EBITDAR for the return on personal property and intangible assets. The DealStats median net rent is just 39.6% of EBITDAR, so the subject would have a higher than typical portion of its EBITDAR allocated to rent. The subject's high rent allocation creates a concern that the rent may be too high, as the third quartile rent ratio is just 51.4% of EBITDAR. The subject's rent is somewhat high compared to other restaurants in DealStats; the subject's rent-to-sales ratio of 10.0% is above the third-quartile level of 8.9% in DealStats. The rent although somewhat high is likely sustainable, assuming there was not excessive debt on the restaurant business. An appraisal of the real estate would suggest a slightly higher than typical capitalization rate, since rent is at a high percentage of both EBITDAR and sales.

But if sales are flat, and the EBITDAR is actually just $125,000, and the business was purchased one year ago for $300,000 ($150,000 for personal property and $150,000 for the business value), then sustainability is an issue. A $240,000 seven-year bank loan at 6% financed the purchase, requiring annual debt service of $42,073. With EBITDA of just $20,000 ($125,000 EBITDAR – $105,000 Rent), there is an annual cash flow deficit of $22,073 after debt service, and there is no return on the buyer's equity of $60,000 (which violates economic law). Unless the owner can (and is willing to) fund the deficit, the restaurant will go dark, barring a significant reduction in the rent or debt forgiveness by the lender. In this scenario, the appraisal should probably project that a vacancy will occur within approximately one year. Inferred demand analysis would provide support for the length of the vacancy period. Some modest cost for tenant improvements to be paid by the property owner would be a prudent assumption. It may be appropriate to adopt a somewhat lower rent of perhaps $30 per square foot for the future occupant given the apparent lower-than-average profit margin at the subject (and high rent to sales percentage). Whether due to management weakness of the current tenant or weakness of the local competitive market, a projection that the subject will likely go dark in the near term is supported.

A discounted cash flow analysis should be performed. The discount rate should be relatively high for most independent restaurants, and the uncertainties facing the subject make it evident that the subject real estate has even higher risk. RealtyRates.com is one of the few surveys that publishes capitalization rates and discount rates for restaurants.

Considering another scenario, if the neighborhood is seeing good population growth, and if there were evidence that sales growth is occurring at the subject such that breakeven sales will likely be achieved within a year, continuation of the current tenancy for the foreseeable future might be concluded.

A reasonable number of sale comparables can be found in DealStats for virtually all types of small businesses. Data does need to be cleaned, as some sales are outliers or simply do not have all of the necessary data points. In situations where

25. Franz H. Ross, "Restaurant Valuation: Industry Segments, Trends, and Impact of Real Property," Business Valuation Resources Webinar, June 22, 2017, 40. Data is from the Pratt's Stats valuation database (renamed DealStats), with transactions included from 2009 to 2017. Adjustments were made to the raw data in this webinar. "MVIC" is market value of invested capital, or the selling price of the business assets, excluding real estate. Owner compensation ("OC") has been normalized.

a going concern value is requested, use of an excess earnings model is recommended to allocate the income (EBITDAR) and values of the component assets (real estate, personal property, and intangible assets) at appropriate capitalization rates for each asset.[26]

When appraising restaurants, auto service shops, car dealerships, and other retail property types, search for good sale comparables in the local market. But, be careful when using sale prices, as sometimes what might appear to be only the real estate price actually may be the price of the going concern. Due diligence in interviewing buyers, sellers, brokers, and others is the only way to truly understand a sale. Using sales of leased properties mitigates this risk, though some bloated sale leaseback prices may include business value.

What Should Bankers Ask For?

Currently, financial institutions are required to obtain independent market value appraisals (for all loans more than $500,000, unless owner-occupied, in which case the starting threshold is $1,000,000). If the Office of the Comptroller of the Currency and other banking regulators want appraisals to assume a second-generation user, then the regulators should mandate that all appraisals be prepared using the extraordinary assumption of a go dark value. Similarly, if the bank's analysis of a loan to an owner-occupied retail business assumes the continuation of the business, and the bank desires an appraisal that assumes the failure of the business, then the bank can request a go dark value in addition to an as-is market value (which may be the same as the go dark value). It is logical for a bank to request a go dark value since the bank's collateral value is most important if the business fails. The highest and best use of the property may be the same or may be different for the second-generation use.

Impact of Recommendations on Appraisers

If appraisers accept the recommendations in this article, it will raise the bar in terms of level of industry knowledge and scope of analysis. Appraisers should decline to appraise a property unless the appraiser has (or will acquire) the necessary industry knowledge to appraise that property type. Unfortunately, if appraisal clients, property owners, and business owners regard financial information as immaterial to retail property appraisals, it will be difficult to advance the level of professional analysis of retail properties.

Conclusions

Appraisers and those with interests related to the retail industry should recognize the following as to the valuation of retail properties.

- Appraisals of both fee simple and leased fee retail properties need thorough market analysis, which may include an analysis of the going concern. For multitenant properties, such market analysis should focus on the property anchor(s).
- Appraisals of owner-occupied fee simple retail properties ideally should consider the going concern aspect. A market rent should be allocated to support the real estate value, with rent analyzed on a per square foot basis, as a percentage of sales, and as an allocation of EBITDAR, as is routinely done for many other property types.
- Strong performing businesses, in ideal locations with build-to-suit improvements, will rarely vacate for a second-generation user. Such properties can sell, but the likely buyer is either an investor in a sale-leaseback transaction or a buyer of the going concern. Weak performing businesses will vacate the property, whether occupied by a credit tenant or owner-occupant, with the question being, when? If the subject location or improvements are not ideal for the business, and there is a superior alternative, the occupant will probably relocate even if continuation of the current use is the highest and best use of the subject real estate. Interview the owner or manager of the store regarding the success (or lack of success) for the store, and the likelihood that the store will remain at its current location.
- The failing property and the very strong performer are both easier to appraise than properties somewhere in the middle. For such middle performers, the risk of failure must be analyzed. In some cases, the appraiser

26. Franz H. Ross and Adam A. Alessi, "Using TEEM-Work to Extend Your Reach on the Real Estate/Business Value Continuum," *The Appraisal Journal* (Summer 2011): 229–239. How to allocate EBITDAR is explained in that article.

may conclude that the property will go dark, while in other cases the real estate should be appraised based upon continuation of the current use, with an adequate capitalization rate and/or discount rate to account for the risk of failure or vacancy for any reason.

- Do not assume a lease renewal without market support. A thorough analysis of the strength of a credit tenant is important in analyzing risk. Beware in considering a tenant as a credit tenant. Blockbuster's credit was worth billions until it was worth zero within just a few years. Leased fee properties necessitate an analysis for the demand of the real estate in its current use. Since store financial statements are rarely available, the appraiser should make several visits to the property. Such visits are likely to be the only evidence of the success of the current use (unless a lease renewal occurred recently).
- In the cost approach, a build-to-suit property generally has specialized improvements that are part of the real estate value for a high performer but for a poor performer represent a superadequacy that must be deducted from value.

Superficial appraisals for retail properties will result in less accurate and less supported valuations, with fee simple appraisals too often assuming a go dark analysis, and leased fee appraisals too often assuming a perpetual income stream. These assumption errors may conflict with both market analysis and highest and best use analysis.

The changing retail environment necessitates change in the way retail properties are appraised. If real estate appraisers extend the methods used for hotels, nursing homes, and other recognized going concern property types to retail properties, both the profession and users of appraisal services will benefit. Retail real estate is sufficiently risky that prudent banks could compel landlords to require ongoing, store-level financial information from their tenants, particularly for risky new development projects, in the same way that banks require financial statements from property owners and loan guarantees by strong entities to mitigate risk. Gaining agreement for change within the appraisal profession is the first step in improving retail property appraisals, and educating users of appraisal services is the necessary second step.

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Additional Resources

Suggested by the Y. T. and Louise Lee Lum Library

Appraisal Institute

- **Education**
  http://www.appraisalinstitute.org/assets/1/7/aiedcat.pdf
- **Lum Library External Information Sources [Login required]**
  Information Files—Retail properties
- **Property Rights Symposium Discussion Paper**
  https://www.appraisalinstitute.org/file.aspx?Document=Property_Symposium_Exp_12-21-17_-_Final.pdf

Federal Reserve of St. Louis Economic Data (FRED)

- **Production & Business Activity: Retail Trade**
  https://fred.stlouisfed.org/categories/
- **Retail Sales: GAFO (General Merchandise Normally Sold in Department Stores)**
  https://fred.stlouisfed.org/series/MRTSMPCSM4400CUSN

US Census Bureau Data

https://www.census.gov/data.html