Through the Looking-Glass: Debunking the "Dark Store" Idiom

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Abstract

This article addresses some of the misunderstanding and mischaracterization around fundamental appraisal terms and methodology, such as *fee simple*, *market value*, and *highest and best use*. In the context of big-box assignments, the discussion explains the label "dark store theory," and unravels its many fallacies and misrepresentations. Using proper and long-standing appraisal interpretations of fundamental terms, the article explains how standard methodology, properly applied, correctly answers the appraisal questions in big-box assignments. The intention is not to disparage ideas or methods, but to unveil the reasons for some of the differences abundant in the current-day appraisal arena.

Introduction

Lewis Carroll's *Through the Looking-Glass* is a novel that presents an alternate version of reality. To a certain extent, the perceptions of reality in the purported "dark store theory" are equally fantastical and controversial. The controversy over these perceptions involves both appraisers and assessors, and concerns the relationship of property rights to market value. This controversy has overflowed into tax courts around the country, where the confusion centers on the methodology for estimating market value of real estate occupied by a first-generation tenant. One side of the controversy seems to argue that this particular property type is a special condition, and therefore it should be valued differently than all others. The other side argues that no special condition exists, and the valuation of such a property should adhere to conventional appraisal methodology.

The controversy was again brought to the forefront by a 2018 article in *The Appraisal Journal*, "Highest and Best Use and Property Rights—Does It Make a Difference?," by Fanning, Wright, and Muenks, which addressed both sides of the debate on valuation of first-generation, build-to-suit properties.[1] Based upon the content of that article and other literature on the topic, however, it is clear there is a general misunderstanding of fundamental appraisal concepts—such as market analysis, highest and best use, and market value—as they apply to build-to-suit properties. The present article will address these issues, then distill them to one fundamental question: Are build-to-suit properties with first-generation occupants so unusual as to require a special valuation methodology?

Property Rights Characteristics and the Valuation Challenge

Market value presumes a transfer of ownership. It is generally recognized that *market value* is the most probable price that a property should bring with consummation of a sale and the passing of title from seller to buyer.[2] The key characteristic

1 Stephen F. Fanning, Larry T. Wright, and Rick J. Muenks, "Highest and Best Use and Property Rights—Does It Make a Difference?" *The Appraisal Journal* (Summer 2018): 171–191.

2. See, for example, the definitions of *market value* in *The Dictionary of Real Estate Appraisal*, sixth edition; the Uniform Standards of Professional Appraisal Practice, 2018–2019 edition; the International Valuation Standards, 2017 edition; and the Uniform Appraisal Standards for Federal Land Acquisitions, sixth edition.

in this context is not the "most probable price" but that title would transfer "from seller to buyer." This is important because there can be no determination of market value without the presumption of there being a second party—an independent buyer. The buyer can purchase either the fee simple or leased fee interest in real estate; consequently, the rights associated with the valuation of a build-to-suit property can be either fee simple or leased fee, depending on the purpose of the appraisal.[3] In the case of a build-to-suit property, the appraisal's purpose will depend on the specific scenario, as noted below.

Scenario One. If the purpose of the appraisal assignment is to estimate the market value of the fee simple interest, and the property is occupied by the build-to-suit owner/occupant, the assignment is straightforward. The valuation is only complicated if the highest and best use conclusion is that the most likely purchaser is an investor—in which case any loss of value due to the risk associated with a lease-up period (as well as tenant quality risk) must be taken into consideration.

Scenario Two. If an estimate of the market value of the fee simple interest is the question, and the property is occupied by the build-to-suit tenant with ownership held by a third party (that is, the owner/occupant of the property sold it to an investor while simultaneously leasing the property back from the investor), the property is nonetheless valued as if available to be leased and as if the occupancy can be delivered with title. As with the first scenario, the valuation is only complicated if the highest and best use conclusion is that the most likely purchaser is an investor—in which case the risk of a loss of value due to vacancy must be taken into consideration.

Scenario Three. If the market value of the leased fee is the question, and the property is occupied by the build-to-suit tenant, the assignment is also straightforward: the property is valued based on the existing lease for the occupied space and market rent for any vacant space, recognizing any possible costs or risk associated with getting the vacant space leased. Caution must be taken, however, to recognize that market rent may be well below or above the contract rent, with enhanced or diminished risk involved.[4]

If the above scenarios seem elementary, that is because they are. There is nothing peculiar about the valuation of a build-to-suit property that cannot be handled by traditional appraisal methodology. The confusion arises when the first-generation build-to-suit sales and leases are treated as arm's-length market transactions for determination of the market value of a fee simple interest. Recognizing that these leases and sales do not meet the definitional criteria of either market rent or market value of the fee simple interest dispels much of the confusion.[5] Understanding the prevalent valuation fallacies presented in the literature should resolve the controversy.

Similar to the discussion in the Fanning, Wright, and Muenks article, the discussion here will rely on a build-to-suit big-box retail store to illustrate the valuation controversy.[6] The discussion will begin with an explanation of "dark store theory" and the valuation mischaracteriza-

3. The discussion here relies upon *The Dictionary of Real Estate Appraisal* definition of *fee simple* as "absolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by the governmental powers of taxation, eminent domain, police power, and escheat." Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 6th ed. (Chicago: Appraisal Institute, 2015), s.v. "fee simple." *Black's Law Dictionary* includes a legal definition of *fee simple*; however, that definition does not reference encumbrances, as is discussed later in this article.

4. Richard L. Parli and Jeffrey D. Fisher, "Risk and Reasonableness for Nonmarket Occupancy—A Second Look during a Recession," *The Appraisal Journal* (Winter 2010): 94.

5. This position is different than that presented in the International Association of Assessing Officers' report *Commercial Big-Box Retail: A Guide to Market-Based Valuation* (Kansas City, MO: International Association of Assessing Officers, September 2017), which ignores the influence of the tenant on a net lease transaction and ignores the property's typical lack of market exposure in arriving at a sale price and a lease rate. While these sales very well may meet the criteria for a leased fee transaction (sale), it is the lack of consistency with the fee simple concept that is the point here. *Commercial Big-Box Retail* report available at http://bit.ly/IAAO-bigbox. See also IAAO draft exposure report, *Setting the Record Straight on Fee Simple* (May 2019), available at http://bit.ly/2za5HDt.

6. *Big-box store* is defined in *The Dictionary of Real Estate Appraisal*, 6th ed., as "A single-use store, typically between 10,000 and 100,000 square feet or more, such as a large bookstore, office-supply store, pet store, electronics store, or toy store" (referencing the ICSC's *Dictionary of Shopping Center Terms*, 4th ed.).

tions that accompany it, then explain the rules associated with application of market analysis and highest and best use that are critical to correctly developing a market value conclusion. The discussion also will clarify the differences between leased fee and fee simple, explain what constitutes a proper highest and best use conclusion, and illustrate how inappropriate incorporation of the business interest of the occupant of the real estate can result in a value in use or investment value conclusion rather than a market value conclusion.

Demystifying Fee Simple Big-Box Valuation: Dark Store Theory Misunderstandings and Mischaracterizations

"Dark store theory" reportedly arose within the past decade among some groups of assessors and appraisers,[7] who have promoted the theory in the media and legislatures without acknowledging that it is contrary to current, generally accepted appraisal practice. In fact, dark store approach proponents have mischaracterized and attempted to discredit accepted valuation methodology, which simply acknowledges that the hypothetical buyer in a fee simple transaction is entitled to occupy the property. In its simplest form, this principle applies to any valuation involving the market value of the fee interest, including a big-box retail store. Traditional appraisal theory recognizes that a second-generation user must be the purchaser of space formerly occupied by a first-generation user. However, a second-generation user does not necessarily indicate *a secondary use* nor does it necessarily result in a distress transaction. Importantly, the methodology must be evaluated in the context of all property types: office buildings, houses, warehouses, and apartments. In the case of houses in particular, the flaws in the dark store approach are clearly revealed.

Dark store theory starts from a mischaracterization of the proper methodology used to estimate the market value of the fee simple interest in big-box real estate. Well-recognized appraisal methodology in the body of knowledge answers the question, What is the market value of the fee simple interest in the subject real estate? As such, a proper answer to the question is based on the transfer of the property, available to be occupied by the hypothetical buyer or a new tenant. This is conceptually identical to how the market value of the fee interest in a house is developed (of course, there is no such thing as "dark house theory"). In the house analogy, the comparables used are sales of similar real estate to a new occupant, a second-generation user,[8] who is eligible to occupy the property upon settlement. Note, this does not require the assumption of vacant comparables—although it does not preclude their use either; quite the contrary, most houses are occupied when sold, but the seller vacates upon settlement. The only thing hypothetical about the sale is that it is assumed to have taken place on the date of valuation after having experienced normal exposure to the market. The buyer is unknown but considered typical, knowledgeable, and acting prudently and with self-interest.

The *property type* is not particularly significant in fee simple valuation issues. Like any other fee simple market value assignment, a big-box fee simple valuation presumes that the occupant (whether the owner or a tenant) will vacate upon settlement. There is no requirement that the property be marketed as vacant or that the property be vacant any time before settlement—just that the current occupant vacate the property at the time of settlement. Consequently, what may seem to be challenges in applying the three approaches to value in a big-box valuation disappear upon close examination.

7. For greater insight into the history of the dark store theory, see Sehvilla Mann, "Taxes, Big-Box Stores and the 'Dark Store Theory'," NPR.org, November 23, 2017, available at https://n.pr/2TLnHxo; Danedri Herbert, "Dark Store Showdown: Executives Back Bus over JoCo Tax Assessments," *The Sentinel*, February 28, 2018, available at http://bit.ly/2Zazsnn; and Laura Bliss, "After the Retail Apocalypse, Prepare for the Property Tax Meltdown," Citylab.com, November 14, 2018, available at http://bit.ly/2MpVThu.

8. *Second-generation space* is defined in *The Dictionary of Real Estate Appraisal*, 6th edition, as "A building or space used by a tenant other than the original tenant; often functionally obsolete before refurbishment but sometimes containing tenant improvements that can be reused by a new tenant." This is differentiated from *first-generation space*, which is defined in *The Dictionary of Real Estate Appraisal*, 6th edition, as, "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." Note, "owner/occupant" can be interchanged with tenant in both definitions.

Application of Income Approach. As with any property, comparable leases of big-box properties are to be identified and investigated in the market. What qualifies as comparable? The first requirement is that the property has a use that is similar to the subject's highest and best use. Since the highest and best use is based on market evidence (and not just on how the property is currently being used), there should be market activity that can provide comparable leases—leases of similar space that have been consummated without the influence of a construction contract or a prearranged agreement.

Similarly, the capitalization rate should be extracted from sales that were not influenced by a construction contract or the credit rating of the tenant. This last point is important because it is well known that most of the net leased credit-tenant sales involve lease payments guaranteed by the tenant. In such cases, the purchaser is buying an annuity with collateral (the real estate). In other words, without that particular tenant, the transaction would certainly not have taken place at the specified capitalization rate. As concerns the identification of an appropriate capitalization rate, finding this with market extraction is problematic, since any sale that would reveal a specific capitalization rate would necessarily be leased. As a result, anecdotal evidence is a better method for fee simple capitalization rate selection.

Application of Sales Comparison Approach. The only rule in applying the sales comparison approach is that the use envisioned by a purchaser of a property must match the subject's highest and best use. Differences in other categories—be they transactional or property specific—can be accounted for through adjustments. There is no adjusting for use differences, however. Secondary uses may evidence the lack or scarcity of market demand. Again, the subject's highest and best use is based on evidence of market activity; this market activity can also be a major source of sale comparables. But without corroborating evidence of the actual interactions of supply with demand, concluding the current use as the highest and best would not be supportable.

The only requirement beyond similar use is that an actual arm's-length transaction occurred without the influence of a construction contract or a prearranged agreement. Concerns similar to those expressed above for choice of a capitalization rate apply here as well.

Application of Cost Approach. As with many assignments, estimating depreciation can be difficult. Many big-box stores have proprietary designs or construction features that are of little value to a second-generation user (for example, super thick, "flat flat floors" that allow high product stacking). The loss in value due to this condition is labeled functional obsolescence superadequacy, although business value issues may also be a consideration. The original developers do not care about the excessive costs associated with the unique design, since the design features added value to their business product, even though not necessarily to the value of the real estate.[9]

Dark Store Mischaracterizations

Standard appraisal methodology (referred to as the "traditional method" by Fanning, Wright, and Muenks) expects the appraiser to treat the build-to-suit retail property as any other retail property. In so doing, the process is assured to be revenue/value neutral, and the outcome of the valuation process is not influenced by the methodology chosen by the appraiser. This is the purported method that Fanning, Wright, and Muenks compare to dark store theory; as presented in that article, however, dark store theory is shown to be a misrepresentation of appraisers' use of traditional methods.

Proponents of dark store theory propose it as an alternate approach while misrepresenting the treatment of comparables in standard appraisal techniques. Problematic areas related to comparables include the following.

- Dark store theory has been described as prohibiting the use of sales of leased properties to value a fee simple estate. Granted, sales of leased property with a first-generation tenant in place through a sale-leaseback arrangement are plentiful. However, for reasons to be discussed below, the rarity of strictly real estate transactions may lead some to believe that there is a prohibition imposed. The application of proper appraisal

9. Douglas D. Lovell, "Does Your Client Really Need a Market Value Estimate?" *The Real Estate Appraiser* (May 1991): 11.

methodology does not preclude using sales of leased property because they are not fee simple sales. In fact, in appraisal reports there is a special adjustment category for *property rights*, which is intended to handle just such issues—if a difference is discernible and an adjustment can be supported.

- Dark store theory has been described as restricting comparable sales to only generic properties since custom-built properties do not meet the value-in-exchange test. Although the choice of comparables is guided by the similarity in appearance with the subject, the fact that the subject or comparable is custom built may reflect on quality and/or depreciation; differences of this nature are clearly expected and can be addressed in the traditional adjustment process. If the market for the subject property is as a generic property, then clearly generic properties would make the best comparables, even if the subject exhibits custom-built qualities.
- Dark store theory proponents also suggest that for the valuation of a big-box retail store with the original first-generation occupant still in place, the comparables must be restricted to sales involving only first-generation occupants. Unfortunately, this would not comport with the question the appraiser has been tasked with answering—which is, What is the value of the fee simple interest?—as most first-generation occupant transactions are sale-leasebacks. Subsequent sales of these properties frequently occur. As explained earlier, however, what sells is often not the real estate per se, but the bond-like rent that was structured when the property was first built. In fact, prospective buyers often do not even inspect the real estate, relying instead on the quality of the income stream. Any use of a sale-leaseback as a comparable would require great care with respect to possible adjustments for the real property rights conveyed and conditions of sale elements of comparison. Often it is impossible to determine which is the dependent variable—the rent or the sale price—since negotiations often involve the two simultaneously.
- Dark store theory proponents also suggest that the only permitted comparables are those involving the sale of properties fully leased at market rent if the subject big box is occupied by the entity for whom it was built (especially if the big-box occupant's business at the subject property is robust). This is fundamentally incorrect. As is clear in highest and best use analysis, it is the physical use that is being studied, not the business taking place in the real estate, that is the key consideration.

Finally, two other mischaracterizations are frequently presented in dark store theory arguments. The first involves the misunderstanding, alluded to earlier, that if one is valuing under the assumption the hypothetical buyer has the right to occupy, then the comparable sales used must be vacant stores, and vacant stores are distressed properties and not representative of market value. As explained with the house analogy, however, most houses are not vacant when sold; they simply must be available for the hypothetical buyer to occupy immediately after settlement. The same is true of big-box properties. They may be occupied up until settlement, but then the buyer must have the right to occupy and the seller must give up the right of occupancy (unless the buyer agrees to an alternative arrangement). Furthermore, there is nothing necessarily distressed about vacant big-box sales. They are usually professionally marketed and maintained (lights and HVAC) during the marketing period. Some vacant stores may be distressed, of course, and they should be handled as they would be under traditional appraisal theory in any appraisal: either discard them as comparables or support an adjustment for conditions of sale.

The final mischaracterization is the idea that by using second-generation sales the appraiser is using properties with a different highest and best use. The argument is that somehow, because the property has been sold by the original occupant, it has necessarily been put to a secondary use. The problem with this argument is that it confuses the success of the business taking place in the real estate with the highest and best use of the real estate. Real estate routinely sells from one user to another without a change in highest and best use. For example, restaurants go out of business for any number of reasons, but the real estate often remains in a restaurant highest and best use. The status of the seller's business and the seller's satisfaction with the property have nothing to do with the valuation problem at hand. It is the real estate that is being valued, not the business taking place in the real estate. As observed in the fourteenth edition of *The Appraisal of Real Estate*, "The concept of highest and best use relates to what is done physically with real estate, and *physical land use should not be confused with the motivation of owners or users*." (Emphasis added.)[10]

Fallacies in IAAO Approach to Big-Box Valuation

While disparaging dark store theory, the Fanning, Wright, and Muenks article appears to demonstrate a third methodology that has been outlined by the International Association of Assessing Officers (IAAO).[11] This methodology concludes that the current occupant of the space defines its highest and best use. Under such a rigid market segmentation interpretation, the highest and best use of the article's case study big-box home improvement store is specifically limited to a retail big-box *home improvement* store. Traditional methodology might conclude the highest and best use is as a big-box retail store, but it is highly doubtful that a specific use conclusion of "home improvement" could be justified outside of its evident occupancy. Furthermore, there is usually nothing specifically related to home improvement real estate that would limit the property's use to a home improvement occupant; most such properties would suit any typical big-box user.

Nonetheless, the specificity of this conclusion is necessary to arrive at the results based on the IAAO methodology. This methodology is premised on three fundamental fallacies that are described below.

Fallacy 1, Nature of the Buyer. The IAAO methodology indicates that market value presumes a hypothetical seller, but the seller can also be the hypothetical buyer. The rationale is that the seller (current owner) should be treated as part of the market of potential buyers since that seller clearly has expressed demand. However, we do know who the seller is—that information is recorded in most local courthouses. The only true hypothetical is that the seller wants to sell, has been marketing the property, and can go to settlement on the valuation date at market value. This known seller cannot occupy any particularly special role in the pool of potential buyers. This would violate the valuation question being asked, as the transaction would not reflect a property available to be occupied by the hypothetical new buyer. This is often countered with the idea that, if one must assume a transaction, which is required in an estimate of market value, the seller—the current occupant—would be in search of an identical premises and therefore would become the most logical "hypothetical" buyer/tenant. Furthermore, because the big box was built to the occupant's original specifications—again, big-box stores are never built speculatively—there would be no functional obsolescence. This argument simply does not work for two reasons. First, even if the seller were to be included in the pool of potential hypothetical buyers, it would not pay more than what other potential buyers in the pool would pay. Secondly, this line of logic would necessarily lead to the conclusion that the market value of every custom-built house should be premised on the tastes and preferences of the occupant for whom it was built, assuming that occupant is still occupying it. Under such an assumption there would never be any functional obsolescence superadequacy, as the owner would be the buyer and the house was specifically tailored to the occupant's tastes. Suffice it to say, this violates almost every element of the concept of market value.

Fallacy 2, Fee Simple Definition. The definition of *fee simple* relied upon in the IAAO methodology (*Black's Law Dictionary*) excludes the consideration of lease encumbrances, whereas the Appraisal Institute definition (quoted earlier) specifically addresses encumbrances. The definition of *fee simple* used by IAAO is, "An interest in land that, being the broadest property interest allowed by law, endures until the current holder dies without heirs."[12] The issue here is that the *Black's* definition is actually meaningless from a valuation standpoint. Since it has nothing to do

10. Appraisal Institute, *The Appraisal of Real Estate*, 14th ed. (Chicago: Appraisal Institute, 2013), 334.

11. Special Committee on Big-Box Valuation, *Commercial Big-Box Retail: A Guide to Market-Based Valuation*, International Association of Assessing Officers, September 2017.

12. *Black's Law Dictionary*, 10th ed., s.v. "fee simple."

with leases, deed restrictions, or other encumbrances, it gives no guidance—or limitation—on what qualifies as fee simple market value: a tenant-occupied building can be deemed as representing the fee simple estate. While this interpretation might be partially true, it misses the point of leased fee, which just describes a situation in which the inheritable estate is subject to leases, and the right to occupy the property has been exchanged for the right to receive rent. This is a well-established concept and is not at all limited to the Appraisal Institute body of knowledge, as has been argued by advocates of dark store theory. It has been suggested that the Appraisal Institute concocted the concept of leased fee interest, and that the concept does not appear elsewhere in the general body of knowledge. Independent third-party materials, however, indicate that the leased fee concept is widely recognized. For example, a close reading of the Uniform Standards of Professional Appraisal Practice, 2018–2019 edition, reveals the term *leased fee* cited twelve times. The Uniform Appraisal Standards for Federal Land Acquisitions (UASFLA), which sets forth "the guiding principles, legal requirements, and practical implications for the appraisal of property in all types of federal acquisitions," includes a discussion of the role of ownership interests as part of its statement of the *unit rule*. The UASFLA states,

> Under the unit rule, the property being appraised must be valued as a unitary whole and held in single ownership. The value of the whole cannot be derived by adding together the separate values of various interests or components. As a result, summation or cumulative appraisals are improper under federal law. The unit rule relates to *ownership* interests (estates) in real estate—such as landlord and tenant, or mortgagor and mortgagee—and to various *physical* components of real estate—such as timber, mineral deposits, farmland, and buildings.[13] [Emphasis in original.]

Clearly, the leased fee concept is not the exclusive purview, or unique concoction, of the Appraisal Institute. A corollary to this fallacy is the misconception that valuing the fee simple interest in a leased property would require a *hypothetical condition*.[14] This is incorrect, just as valuing the land under an improved property does not require a hypothetical condition.[15] There is no need for a hypothetical condition in either case.

A significant consequence of the misinterpretation of fee simple by those who cite dark store theory is that a property that is occupied on the date of appraisal, and for which the market value of the fee simple is being estimated, must be valued as if leased at market rent and stabilized occupancy. This is problematic on a couple of levels. First, consider two identical office buildings, one built speculatively and the other built to suit and fully preleased. Their fee simple interests would be equal while the values of the respective leased fee interests would be different. As *The Appraisal of Real Estate*, fourteenth edition states, "If there are leases in place, even at market rents and terms, the interest is a leased fee."[16] If the question the appraiser is asked to answer is, What is the market value of the fee interest in the subject real estate?, then each of the three approaches to value must be analyzed as if the property were available to be leased at market rent, with no leases in place. As such, no modification to the cost approach would be necessary, but the income approach would have to recognize the possibility of a loss in value caused by the need to create the lease, and the sales comparison approach would have to consider the possibility that an adjustment might be needed to comparable sales that were leased when sold.

Fallacy 3, Sale-Leaseback as Market Rent. The final fallacy in the IAAO committee's methodology is that market rent and market value are reliably expressed by a sale-leaseback transaction

13. Interagency Land Acquisition Conference, Section 4.2.2 in *Uniform Appraisal Standards for Federal Land Acquisitions*, 6th ed. (Washington, DC: US Department of Justice, 2016); available at http://bit.ly/UASFLA.

14. The Appraisal Institute's Standards of Valuation Practice define a *hypothetical condition* as "a condition that is presumed to be true but is known to be false." (Lines 23–24) The Uniform Standards of Professional Appraisal Practice, 2018–2019 edition, defines a *hypothetical condition* as "a condition, directly related to a specific assignment, which is contrary to what is known by the appraiser to exist on the effective date of the assignment results, but is used for the purpose of analysis." (Lines 124–125)

15. See Appraisal Standards Board, "Frequently Asked Question 184, Appraising Only the Underlying Land of an Improved Property," in *USPAP Frequently Asked Questions*, 2018–2019 ed. (Washington, DC: The Appraisal Foundation, 2018).

16. Appraisal Institute, *The Appraisal of Real Estate*, 14th ed. (Chicago: Appraisal Institute, 2013), 6.

since both transactions are arm's length and both parties agree that the rental rate and sale price are set at market. This is a clear fallacy *unless* the analysis is based upon detailed research that addresses and takes into consideration the buyer and seller motivation. Both the Appraisal Institute and the Appraisal Foundation recognize sale-leaseback transactions to be financing arrangements that do not meet the definition of market rent.[17] *Sale-leasebacks* are "transactions in which real estate is sold by its owner-user, who simultaneously leases the property from the buyer for continued use."[18] In such a transaction, there was no independent negotiation of either the sale price or the rent.

Subsequent sales of these properties frequently occur. What sells, however, is not the real estate per se but the corporate bond-like rent that was structured with the sale-leaseback. Any use of a sale-leaseback as a comparable would require great care with respect to possible adjustments for the real property rights conveyed and conditions of sale elements of comparison.

Furthermore, the property in this situation was never exposed to the market for rental purposes and the contract rent does not meet the definition of market rent. In fact, when these leased stores are vacant there is often no incentive to re-lease the real estate since the landlord will receive rent regardless of occupancy. And, if offered for rent at the leaseback rate, the space often remains vacant.

Market Analysis and Highest and Best Use under the IAAO Approach

The case study market analysis and highest and best use conclusion in the Fanning, Wright, and Muenks article can make sense only if the fallacies of the IAAO approach are accepted as correct. What is demonstrated in that article's highly limited market analysis is only that the property is in a growing market, is occupied, is one of two such stores in the market area, and may be slightly outperforming the national average of sales per square foot. The property's actual success is inferred from customer activity. From this observation and the limited data, the case study concludes that the highest and best use is continued use as a big-box home improvement store. It is worth noting that the case study's narrow conclusion of highest and best use—as a big-box *home improvement* store (not any other type of big-box retail store)—is not based on market activity but on the apparent viability of the tenant's operation in the real estate. However, a highest and best use conclusion must necessarily be based on evidence of market activity (leases, sales, etc.), without which the valuation process is handicapped through a nonexistent pool of potential comparable market sales and leases.

As stated above, the article accepts the *Black's* definition of *fee simple*, thereby allowing it to answer the question of whether property rights matter to a highest and best use conclusion. Ironically, the article claims to answer the question in the negative while making a perfect case for the affirmative. The article references a property with a lease with a remaining term of twenty-three years as an example (pages 177–178). The existence of this lease, being a legal limitation on the use of the property for the next twenty-three years, would certainly influence the highest and best use of the property—unless leases are not a relevant consideration.

Summary and Conclusions

Much of the misunderstanding about proper valuation methodology is exacerbated by labels designed to mischaracterize the methods. Such is the case with dark store theory. Usually used in the context of valuing big-box real estate, dark store theory is built on rigid and artificial interpretation of some key appraisal terms, namely *fee simple*, *market value*, and *highest and best use*.

With respect to fee simple, the dark store theory interpretation is that fee simple has nothing to do with leases in place, and therefore an assignment to value the fee can be accomplished by merely assuming the property is fully leased at market rent. Regarding market value, the dark store theory premise is that an occupied store must be valued as fully occupied, and empty stores cannot be used as rent or sale comparables in the analysis. Finally, highest and best use is construed

17. See *The Appraisal of Real Estate*, 14th ed., 466; and Appraisal Practices Board, *APB Valuation Advisory 2: Adjusting Comparable Sales for Seller Concessions* (Washington, DC: The Appraisal Foundation, 2012), 15, available at http://bit.ly/AdjustingComparables.

18. *The Dictionary of Real Estate Appraisal*, 6th ed., s.v. "sale-leaseback."

to ignore leases and is defined rigidly by the business taking place within it. Thus, a big-box property successfully occupied by a home improvement business would necessarily have a highest and best use as a home improvement big-box store. The fragile nature of this approach is evident if the possibility is considered that the business may be so successful as to outgrow the store, creating need for a new, larger store. The original store now sits vacant, but has its highest and best use changed?

Proper appraisal methodology has long recognized that valuing the fee simple interest is not the same as valuing the leased fee, regardless of the relationship of contract rent and market rent. By using highly constrained interpretations of leased fee, market value, and highest and best use, it is possible to corrupt fundamental valuation principles and methodology to suit the appraisal report user's purposes. This interpretation is very similar to the Humpty Dumpty Theory of Language as portrayed by Lewis Carroll in *Through the Looking-Glass*, in which Mr. Dumpty famously states, "When I use a word it means just what I choose it to mean—neither more nor less." This, of course, is simply not true. Fortunately, by focusing on principled terminology and accepted methodology, it is clear that no special methodology is necessary to value the fee simple interest in a big-box retail property currently used by the first-generation occupants for whom the real estate was custom built. As demonstrated in this article, these properties should be valued using the very same, fundamentally sound, methodology that is appropriate for any property when the market value of the fee simple interest is being sought.

About the Authors

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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 Resources Knowledge Base [Login required]**
  - Information Files—Special use properties/retail properties/big-box stores
  - Information Files—Taxation and assessment
  - Information Files—Value
- **Property Rights Symposium Discussion Paper**
  http://bit.ly/SymposiumPaper

Calkain—Net Lease Investments Explained
https://www.calkain.com/net-lease-101/

CCIM Institute Site to Do Business
https://www.stdb.com/

Federal Reserve of St. Louis, FRED Economic Data
https://fred.stlouisfed.org/

National Real Estate Investor—*Net Lease Trends Reports*
https://www.nreionline.com/nrei-research-series/net-lease-trends