Valuation Viewpoint

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CONDITIONAL AND GRANDFATHERED USES COMPLICATE THE APPRAISAL PROCESS

BY: TIMOTHY A. RYE

Introduction

From time to time, appraisers are engaged to value properties impacted by conditional use permits (C.U.P.s) or grandfathered use designations. For properties of this nature, it is a challenge for the appraiser to appropriately identify and assess the effects of the C.U.P. or grandfathered use on market value.

Conditional use permits allow city planners to regulate specific uses that are not generally desirable in certain districts and do not conform to current zoning ordinances. Planning commissions may approve a specialty use in a specific location if it complies with the majority of the conditions and standards of the area and fits into the scope of the city's master plan. Prior to granting a conditional use permit, city planners review development plans and assess possible impacts on existing and future businesses. The zoning committee may also require that additional restrictions are met before issuing a C.U.P.

If, for example, a business owner desired to establish an auto repair facility (commercial use) in an area zoned for warehouses (light industrial use) he or she would apply for a conditional use permit. While an auto repair shop does not meet the city's zoning criteria for business parks, it is not a completely incompatible use. Because the potential for large open areas of parked cars and auto parts exists with this use, but is not allowed under current zoning ordinances, the business owner and the city planners will lay out the conditions under which a C.U.P. will be granted.

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MARKET TRENDS AND INDICATORS

Office Buildings	↓	1%
Retail Centers	↓	2%
Industrial Buildings	↓	6%
Apartments	↓	3%
New Housing Starts	↓	25%
Productivity	↓	1.6%
Composite PE	↓	24.0
Consumer Confidence Index	↓	87.9

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MARKET TRENDS AND INDICATORS

ECONOMIC INDICATOR

	2002	2003	2004	2005	2006	2007
New Housing Starts—Yearly Totals	349,600	374,100	355,700	357,400	279,500	210,600

P/E RATIOS IN SELECT INDUSTRIES

Reporting categories changed in spring of 2006. Data for the current categories is presented for the Year 1006, quarterly for 2007 and Year 2007.

Industry (Year end)	2006	1Q 07	2Q 07	3Q 07	4Q 07	2007
Basic Materials	13.7	14.9	12.8	13.2	15.5	14.1
Conglomerates	20.1	19.8	17.7	17.6	18.4	18.4
Consumer Goods	25.8	27.3	27.7	23.0	19.5	24.4
Financials	14.3	15.8	14.2	13.3	11.4	13.7
Healthcare	38.8	57.1	39.3	33.2	30.3	40.0
Industrial Goods	25.1	18.9	19.0	19.5	20.6	19.5
Services	25.6	27.1	25.6	27.1	34.8	28.7
Technology	26.3	27.7	33.0	51.9	41.2	38.4
Utilities	24.0	30.2	20.0	19.3	18.6	20.0

	2006	1Q 07	2Q 07	3Q 07	4Q 07	2007
All Industry Composite P/E Ratios	**24.4**	**26.6**	**23.8**	**26.2**	**24.5**	**24.0**

ECONOMIC INDICATORS

Indicator (5 yr. avg.)	1985	1990	1995	2000	2005	2006	2007
Inflation	5.0%	4.0%	3.1%	3.4%	3.4%	2.0%	4.1%
Productivity	1.7%	0.6%	1.5%	2.9%	1.8%	1.5%	1.6%
GDP	4.0%	1.8%	2.7%	3.8%	3.5%	3.2%	2.2%
Consumer Confidence	84.9	104.2	99.2	128.6	107.2	105.6	87.9

RATES OF RETURN AND RISK HIERARCHY

Investment	Current
30 Year Treasury	4.4%
Aaa Bond	5.4%
Bbb Bond	6.2%
Commercial Mortgage	5.25–6.25%
Institutional Real Estate	6.5–7.5%
Non-Institutional Real Estate	8.0–10.0%

Investment	Current
Speculative Real Estate	10.5–14.5%
S & P Equity (Ibbotson)	11.5%
Land Development	11–17%
Equipment Finance Rates	14%
NYSE/OTC Equity (Ibbotson)	15.4%
NYSE Smallest Cap. Equity (Ibbotson)	21.2%

Sources: National Real Estate Index (2008), Appraisal Institute; F.W. Dodge Division, Business Week, Value Line, U.S. Chamber of Commerce, Standard & Poors, Investment Dealers Digest, U.S. Government Census, Yahoo Finance.

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VALUING UNDIVIDED PROPERTY INTERESTS

BY: CHARLES A. MILLER AND SCOT A. TORKELSON

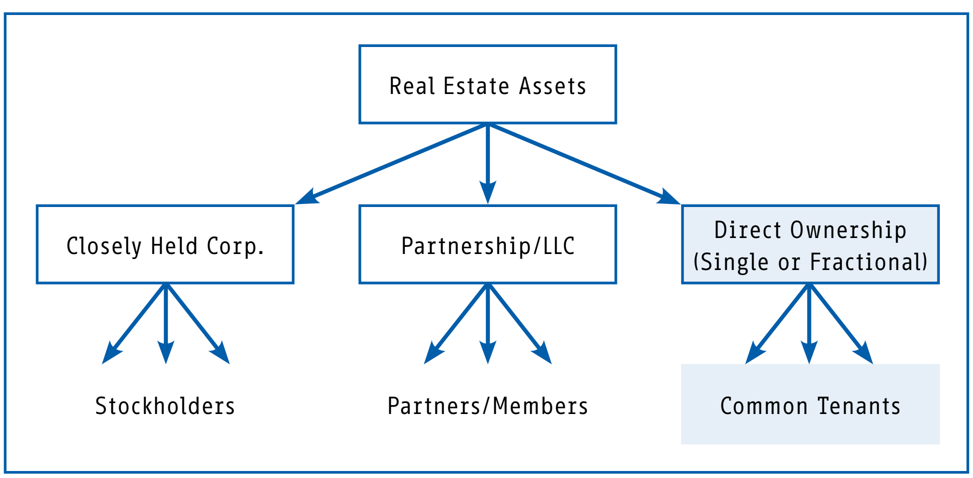
There are many forms of ownership for real estate assets: Closely Held Corporations, in which the owners are stockholders; Partnerships, in which the owners are partners or members; and Direct Ownership, where the owners are common tenants. Within each ownership type, the owners have certain rights and responsibilities. This article focuses on the factors which affect the value of the undivided fractional interests of common tenants. Common tenancy exists when more than one person has an ownership interest in the same property at the same time. Although common ownership interests can occur with any type of underlying asset, our discussion is limited to undivided interests in real estate.

An undivided property interest is typically created among family members or between persons in a relationship. The arrangement is often the result of no planning—it just happens. Predictably, this can lead to annoying misunderstandings among the common owners—at one end of the spectrum and lengthy litigation disputes—at the other end of the spectrum. Recent statutory reforms have changed the nature of shared interests themselves, the tax consequences associated with this type of ownership, and the methods of valuing the interests. There are two types of undivided interest situations: the joint tenancy agreement and the tenancy in common agreement.

Joint Tenancy

Joint tenancy is defined as the ownership of real estate by multiple individuals under the same deed with the right of survivorship. Joint tenancies are determined by the five "unities."

- **Unity of Interest**—owners share one and the same interest
- **Unity of Time**—ownership commences at one and the same time
- **Unity of Title**—ownership interests are created by a single deed; consent is required to encumber the property
- **Unity of Possession**—ownership of the undivided interest is of the whole property
- **Unity of Person**—owners have the right of survivorship



When one joint tenant dies, the interest of the deceased tenant is terminated. The surviving tenant is entitled to exclusive possession and surviving tenant's interest is correspondingly enlarged.

Tenancy in Common

Tenancy in common is a form of ownership whereby each owner holds an undivided interest in the property. Here, there is only *unity of possession*, i.e., an undivided interest in the whole property, not merely separate divisions of the property. Titles are separate and distinct. The owners have a shared ownership interest in the common areas, but upon the death of one owner, his/her ownership interest passes to the heirs, not to the surviving owners. 100% of the decedent's undivided interest in the property is included in the decedent's gross estate. Tenancies in common do not have the right of survivorship.

History of Tenancy in Common

In Europe during the Middle Ages, peasants were legally bound to live and work in one place—in servitude to the wealthy landowners. In return for working the owner's land, the peasants received: a house and some farm animals; a small adjoining plot of ground; a share of the surrounding fields and protection from outlaws and other lords. This "sharing of the fields" with other farmers formed the basis of the "commons" or "tenancy in common." The resulting relationships and rules related to tenancy in common originated in this period and pre-date modern democracy.

> "*Common tenancy exists when more than one person has an ownership interest in the same property at the same time.*"

Rights and Duties of Co-tenants

Co-tenants, irrespective of the type of tenancy, share certain rights relative to each other and to the property, except to the extent they have modified these rights through an agreement among themselves. Each tenant has an unrestricted right of *access* to the property. Where one co-tenant wrongfully excludes another from making use of the property, the excluded co-tenant can bring a cause of action for 'ouster,' *and may receive the fair rental value of the property for the time that he was dispossessed*. Each tenant has a right to an *accounting* of profits made from the property. If the property generates income such as rent, each tenant is entitled to a pro-rata share of that income. Each tenant has a right of contribution for the costs of owning the property. Co-tenants can be forced to contribute to the payment of expenses such as property taxes and mortgages on the entire property. Co-tenants do not have an obligation to contribute to any costs of repairing or improving the property. If one co-tenant adds a feature that enhances the value of the property, that co-tenant has no right to demand that any of the others share in the costs of adding that feature even if the other co-tenants reap greater profits from the property because of it. However, in situations where a partition lawsuit is undertaken, a co-tenant is entitled to recover the value added by his or her improvements of the property.

> "*The resulting relationships and rules related to tenancy in common originated in this period and pre-date modern democracy.*"

Conversely, if the co-tenant's "improvements" decrease the value of the property, the co-tenant is responsible for those decreases as well. Each co-tenant can independently encumber the co-tenant's own share in the property by taking out a mortgage on that share. Other co-tenants have no obligation to help pay a mortgage that only runs to another tenant's share of the property. The mortgagee can foreclose only on that mortgagor's share. In tenancy in common arrangements, each owner can mortgage his or her interest, but under a joint tenant arrangement, there is one mortgage for all owners.

If any party to a tenancy in common wishes to terminate the joint interest, he or she can do so through a partition of the property: a division of the land into distinctly owned plots—if such a division is legally permitted. If such a division is not legally permitted, the joint interest may be terminated by a forced sale of the property followed by a division of the proceeds. When the parties do not agree to a partition, any or all of them may seek the ruling of a court to determine how the land should be divided. The land may be physically divided among the joint owners (partition in kind), leaving each with ownership of a portion of the property representative of his/her partnership interest. The court may also order a partition by sale in which the property is sold and the proceeds are distributed to the owners commensurate with the shares owned. When local law does not permit physical division, the court must order a partition by sale.

"*It is essential to define the valuation problem and thoroughly understand the attributes of the subject interest before determining the most appropriate valuation approach or approaches to use.*"

Valuation Process

In order to value a co-tenant's interest, one must collect all the necessary data required to understand the subject interest such as obtaining: an accurate description of the ownership interest, copies of any agreements among the owners, pertinent financial data, and any other relevant information. It is essential to define the valuation problem and thoroughly understand the attributes of the subject interest before determining the most appropriate valuation approach or approaches to use. The appraisal process for the ownership of an undivided interest in real estate is similar to the process used in the analysis of other forms of real estate asset ownership. The basic steps follow:

- Define the appraisal problem
- Describe the ownership interest
  - Ownership group history and percentages
  - Distributions
  - Real estate assets—description
  - Past sales of interests
- Analyze the ownership attributes and any agreements
- Develop the value of pro-rata equity (use the Asset Approach for real estate)
- Develop discounts for lack of control and lack of marketability
- Calculate the value of the subject interest

During the valuation process, keep the following questions in mind:

- Are there any relevant legal issues?
- Does the agreement provide for property management, policies, fees, and other factors which affect control and marketability? For example, in an agreement, the co-tenants may give up rights of partition which negatively affects marketability. Conversely, the co-tenants may be afforded a put option which enhances marketability.

- What is the nature of this ownership group?
  - Is a partition suit likely?
  - Is the membership group cohesive?
- Is a sale of the property likely to occur; if so, when?

Appraisal Professionals

At a high level, the ownership of real property is a business, and the valuation of the different forms of real estate ownership broadly fall within the business appraisal discipline. However, the specific knowledge required to appropriately value the real property assets as well as the necessary state licensure required to appraise real property in the U.S. typically falls outside of the qualifications of most business appraisers. Similarly, the business valuation elements required to value a fractional interest are not typically part of the real property appraisal body of knowledge. Therefore, the appraisal of an undivided interest in real estate is typically a multi-discipline process involving specific knowledge in both the appraisal of real property and business valuation. As a result, it is common for two different practitioners to be involved in the appraisal of an undivided interest in real estate.

> *"Because no one co-tenant has the right to sell or terminate his/her interest at will, one must discount the value of the subject interest."*

Typically, the real property appraiser values the whole real estate asset following the appraisal process as defined by professional standards bodies and the state in which the property is located. The business valuation professional performs any necessary balance sheet adjustments, prepares any financial forecasts specific to the undivided interest, analyzes the ownership structure and agreements, and develops any applicable minority and marketability discounts.

Asset Approach to Value for a Pro-Rata Interest

The asset approach is typically the most appropriate approach to value used to arrive at the pro-rata value of the equity (before discounts) for an undivided interest in real property. An appraisal for the 100% interest in the real property is often performed by a real estate appraisal professional. Subsequently, that appraisal is analyzed by a business valuation professional. When analyzing the real estate appraisal, it is important for the business valuation practitioner to note any assumptions or conditions which affect future cash flows, holding time, discount rates, etc. He/she must also:

- Review the financial statements and determine what adjustments should be made.
- Adjust the real estate asset to market value on the balance sheet analysis.
- Subtract any relevant debt obligations to arrive at the adjusted 100% equity value.

An example of the type of calculation the business valuation professional might use follows:

ASSET APPROACH—WORK SHEET

Market Value of Real Estate*	$3,000,000
Less Real Estate Debt	−$1,000,000
Market Value of 100% Equity Interest	$2,000,000
Subject Percent Interest	50%
Pro rata Value of Subject Interest (before discounts)	$1,000,000

* Assumes no improvements attributable to any single co-tenant

Discount Analysis

Because no one co-tenant has the right to sell or terminate his/her interest at will, one must discount the value of the subject interest. Discounting the market value for a lack of control and a lack of marketability provides a method of arriving at a realistic value of the subject interest. What discounts does one use and why? The following methods are often used or considered by business valuation professionals in the discount analysis of an undivided interest in real estate.

- We can use a direct application of discounts from lack of control minority discount studies (LOC discount) and the lack of marketability discounts from restricted stock studies (LOM discount). Although the studies relate to discounts for stockholders, the basic reasons for a discount are the same for stock as they are for tenancies in common in that both forms of ownership have attributes that lack control and both forms of ownership have a very limited market to sell. However, because the ownership attributes and risk profiles of the entities themselves differ, adjustments must be made. The typical tenancy in common has superior control and often requires less management (lower LOC discount) than stock ownership. Normally, a tenancy in common ownership in real estate is based only on tangible assets while stock ownership in an operating company may involve significant intangible assets. In aggregate, the ownership of stock in operating companies is often a much riskier asset class than real estate (lower LOM discount).
- A direct application of data from fractional interest transactions (combined discount) is, potentially, the purest form of valuation if comparable transactions are available. This type of data is very hard to find, but there are some published studies which discuss combined discounts for undivided interests in real estate. Combined discounts are aggregate discounts which factor in both the lack of marketability of the interest and the discount for a fractional ownership position.
- Business valuation professionals may consider relying on the sale data from private real estate partnership interests and the resulting discounts (combined discount) as provided in Partnership Profiles. This publication tracks and reports the sales of minority interests in real estate partnerships, organizing the data based on the underlying type of real estate. Again, the indicated discounts must be adjusted because the tenancy in common ownership (undivided) typically has superior control compared to those of private partnerships.
- Data estimating the cost to partition (combined discount) may be available in certain cases. The cost to partition analysis involves an analysis of the time and cost necessary for the subject interest to realize full pro rata value of the whole. Realistically, however, the property may not be divisible. Further, costs and time to settle could vary greatly depending upon the number of parties involved, whether the partition is contested, and the complexity of the partition.

> *“Appraising an undivided interest in real property is typically a multi-disciplinary process that involves the services of both a real estate appraiser and a business valuation professional, or someone who is qualified in both fields.”*

A study of data from 158 partition suits, during the years 1978–1994, revealed costs of up to $50,000 for each party involved and an average of three years to resolve contested actions.

- Finally, one might use an income approach model to arrive at a value for the subject interest. The income approach to value is an appropriate approach to consider when the subject underlying real property is income producing property and especially if there is a real estate appraisal available that lays out the financial projections, holding period, and risk assumptions. In this approach, the business valuation professional develops a discounted cash flow scenario based on: cash flows directly to the subject interest; estimated holding period; and incremental required rate of return for the subject interest. Depending upon the input assumptions, cash flow models can be very sensitive.

Conclusion

Appraising an undivided interest in real property is typically a multi-disciplinary process that involves the services of both a real estate appraiser and a business valuation professional, or someone who is qualified in both fields. Valuing a fractional undivided interest in real estate is different from valuing the typical partnership or corporation interest. In the case of an undivided interest, the business valuation professional must take into account the unique attributes of the tenant in common agreement. These factors influence the quantification of the appropriate discounts applied for lack of control and lack of marketability. There is no foolproof method of determining discounts. A valuation professional experienced in the unique attributes present in the ownership of an undivided interest in real estate is best able to address those unique attributes in order to arrive at an appropriate value opinion.

Shenehon Company is proud to announce that Senior Appraiser

CHRISTOPHER J. STOCKNESS

has obtained his Certified General Real Property Appraiser's License.

Chris came to Shenehon with a degree in Real Estate from the University of St. Thomas. In five years, he successfully completed the required coursework and over 3000 experience hours in the area of commercial real estate appraisal. He passed the Minnesota licensing exams in August of 2007.

CONGRATULATIONS, CHRIS!

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While C.U.P.s regulate and control new property uses which do not conform to current zoning standards, grandfathered uses allow businesses already in place to continue operating. Consider what happens when the city takes land from a property owner for road expansion. A building on the affected property, previously in conformance with zoning laws, may now be located too close to the property boundary. It violates new setback restrictions and no longer meets the zoning requirements. Cities often employ the grandfathered use provision of the zoning code to authorize continued operation of a non-conforming property.

Communities rely on standards of development and special permits to facilitate their long term development plans. A grandfathered use designation could prevent/encourage redevelopment; it may mitigate the impact of an eminent domain taking. A grandfathered use permit may also define the terms under which the business can continue to operate before it must come into compliance with current zoning requirements. The city's vision does not always mirror the vision of a property owner, developer or the market itself. A property operating with a conditional use permit or a grandfathered use permit may be viewed as an asset or a liability in the market. Quantifying this premium or discount presents a unique challenge for owners, managers, attorneys and appraisers. The following discussion illustrates how an appraiser identifies and measures the impact of a special use permit or a grandfathered use designation on a property's value.

Valuing Property Impacted by a Conditional Use Permit

The appraiser must have a thorough understanding of all the facts in order to quantify any enhancement or discount to the property value that is a result of a conditional use permit. In order to measure the impact of the C.U.P., it is necessary to determine exactly what the permit allows or restricts. Following discussions with city officials and a general review of the zoning codes, the appraiser focuses on the conditional use permit section of the city's code. He/she must now determine whether the conditional use permit is restrictive or permissive. A restrictive conditional use permit allows the non-conforming use but places physical restrictions such as size, height, parking, screening, noise, etc., on the business—an inward focus on the property. A permissive conditional use permit also allows the non-conforming use within the zoning class but, in addition to restricting physical characteristics, it also places conditions on where, within the zone, the business may be located—an outward focus on the property. For example, the non-conforming business may be subject to distance requirements between it and other businesses: as in the restriction that a pawn shop be at least one mile from a public school. Once the city agrees to issue a conditional use permit, the owner must prove that all restrictions have been met and that neighborhood approvals have been obtained. These challenges may limit the number of permits actually issued.

> *"It is a challenge for the appraiser to appropriately identify and assess the effects of the C.U.P. or grandfathered use on market value."*

The ease or difficulty of obtaining a C.U. P. reflects on the economic potential of the permit itself. The appraiser must understand the basic supply/demand equation for a particular use: how often are requests made for a given C.U.P. and how often are they granted?

Consider an industrial property with an open yard storage conditional use permit. Does the city limit the number of such permits in a given area? Is there a demand for additional such permits? Is there neighborhood opposition to additional open yard storage permits? If supply does not equal demand, the conditional use may truly be unique. If no other property can function in the same capacity in the area, the C.U.P. may provide a measurable premium or benefit to the property owner.

It would seem that if the market supports the non-conforming use, it is an indication that the C.U.P. has a positive economic effect on the subject property. However, the relationship is not so easily defined. To illustrate the complexity of zoning variations, let's compare two properties which are identical except that one has a C.U.P. and the other does not. Assume the following facts:

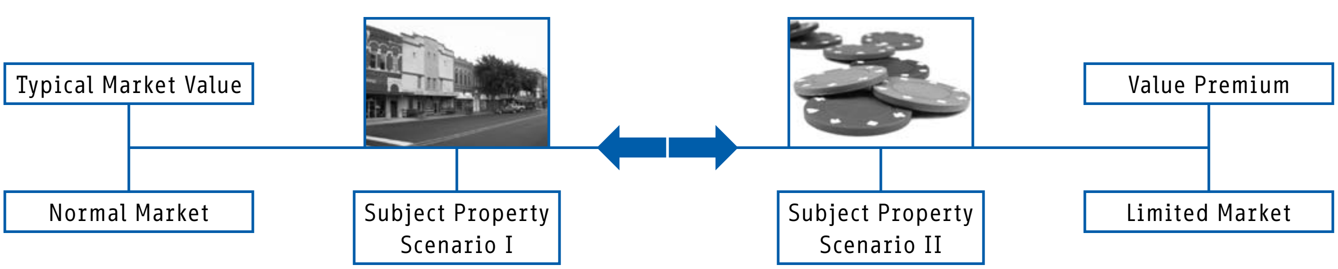
- The property is zoned commercial; casino use is prohibited within the commercial zone, but is allowed with a conditional use permit;
- Video lottery casino conditional use regulations require connection to a commercial zoning district as well as an attached on-sale liquor license;
- Additional requirements do not allow casino use within 2,000 feet of schools, churches, other casinos, bars or day care facilities;
- The C.U.P. relates to the land and cannot be moved;
- Market is made up of 200 video lottery casinos in the town many of which are non-conforming uses (operating under grandfathered use status due to zoning code changes).

When supply meets demand, market values are stable creating economic equilibrium. If supply is high and demand is low, equilibrium is not achieved and prices will fall until supply equals demand. Based on the location restrictions in our assumption, only a handful of sites legally permitting a new casino remain in the city and those locations have already been eliminated as a result of neighborhood opposition. Thus, supply is limited or fixed and, as demand increases, we would expect prices to increase as well. Such a price increase may be considered a premium resulting from the C.U.P. restrictions. This hypothesis can be tested by comparing the general market rent levels in the area which are not supported by video casino sales to market rent levels in the same area which are supported by sales activity in video casino sales. Following, are two scenarios for valuing a commercial property. Using the assumptions outlined above, Scenario I is based on a typical commercial building without a conditional use permit for a video casino and Scenario II is based on an identical commercial building with a conditional use permit allowing a video lottery casino use.

> "*If no other property can function in the same capacity in the area, the C.U.P. may provide a measurable premium or benefit to the property owner.*"

Scenario I:

Assume a general purpose 1,000 square foot commercial property with no conditional use permits. It is located in an average retail area with no deficiencies or superiorities. We will use the income



capitalization approach to determine market value. The standard income approach for this type of property is derived by capitalizing a net operating income which is based on market rents.

If retail comparables in the area indicate a market rent of $10.00 per square foot net of expenses, the gross income for the subject property is $10,000. We assume a 10% loss for non-reimbursable expenses, resulting in a net operating income of $9,000. Applying a capitalization rate of 8%, the calculation of market value, using the income capitalization approach, is as follows:

$9,000 ÷ 8% = $112,500

This estimate represents a typical market where supply and demand are at equilibrium. It serves as the baseline value for estimating the economic impact a conditional use permit has on market value.

Scenario II

In Scenario II, we consider the same 1,000 square foot commercial building, in the same retail market but with a video lottery casino conditional use permit. It is one of 200 locations allowed to operate as a video casino lottery. In order to apply the standard income approach to the subject property with its C.U.P., we must look for comparable market rents which reflect the change in use. There are few sales of video casino lotteries indicating that they do not often change hands. While the building itself may still function at the rents used in Scenario I, the property now has a different use which results in a significant change in market rent.

For illustrative purposes, let us assume a market rent for casino properties of $30 per square foot net; the gross income for the subject property is $30,000. Based on a 10% non-reimbursable expense rate, we calculate a net operating income of $27,000. Applying a capitalization rate of 8%, the income capitalization approach produces the following value:

$27,000 ÷ 8% = $337,500

The above estimated value clearly indicates that a premium over the typical market exists. It is important to figure out why the premium exists and how accurate our assessment of the premium is. Because video casinos function like other retail properties, we know there is a relationship between sales revenue and rent. One way to quantify that relationship is through a percentage of sales analysis.

A percentage of sales analysis allows us to determine rent; from the rent, we can determine the value. Rent is derived from a percentage of gross revenues of the business in the space. The appraiser may use industry recognized percentages, for example fast food stores use percentages between 4% and 6% with the lower percentage applying to stores with higher per square foot sales and the higher rate to stores with lower sales per square foot. Percentages can also be determined through open negotiations when an industry standard is not available. This is effective for unique uses that cannot rely on industry standards.

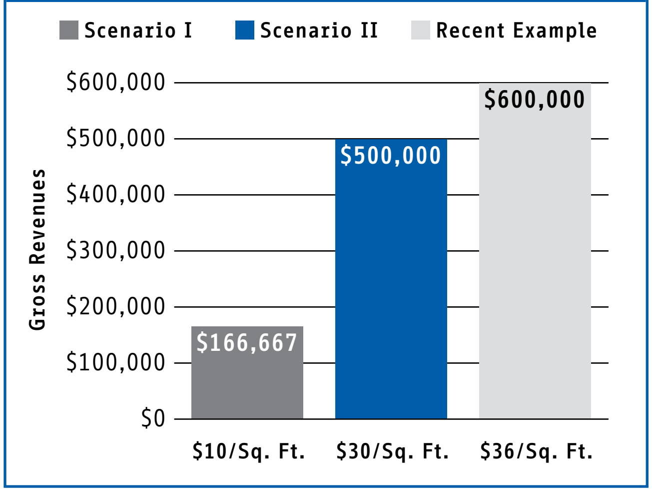
> *"Industry standards and general due diligence requirements mandate that the appraiser base the final value estimate on the property's highest and best use."*

In Scenario I, our typical market retail property had $10,000 in annual gross income. If we work backwards, we can use a percentage of sales to determine the level of revenues represented in the typical retail market. Using 6% of sales ($10,000 ÷ 6%), we calculate $166,667 in gross sales revenues. In Scenario II, the video lottery casino showed $30,000 in annual gross income. Using a 6% of sales ($30,000 ÷ 6%), we calculate $500,000 in gross sales revenues. Annual sales in our two scenarios are strikingly different, with the general retail property generating roughly $166.67 per square foot in sales and the video lottery casino generating $500 per square foot in sales.

Investors and property owners recognize that a specific property location or use may benefit the operative business on the site. When this is the case, an effectively crafted lease will reflect this premium. Some of the revenue premium returns to the property owner in the form of higher rent. An in-depth analysis of actual financial statements for businesses similar to our Scenario II video lottery casino reveals the extent of the premium generated by the conditional use permit. Recently, we encountered a casino (featuring the above assumptions) with annual revenues of $600,000. Even if we consider $500,000 in annual revenues (Scenario II), as average and $600,000 (actual revenues), as above average, we still see a significant premium over revenues from the basic retail facility in Scenario I with its $166,667 in annual revenues. The only difference between the two types of facilities is the existence of the video lottery casino permit.

In our hypothetical situation, the value difference between a typical retail property ($166,667) and the casino property ($500,000) is $333,333. In this case, the premium due to the conditional use premium is $333,333. If we ignore the fact that there is a C.U.P. associated with this location, we severely underestimate the market value of the property. While most conditional use permits reflect simple variances from common uses and performance requirements, sophisticated investors recognize that a C.U.P. may significantly affect market value. Regardless of whether one is buying or selling, it is essential to have the property appraised. Industry standards and general due diligence requirements mandate that the appraiser base the final value estimate on the property's highest and best use. Appraisers, attorneys, brokers and owners who recognize that a conditional use permit impacts the highest and best use of a property will make the most of the premium or discount it generates.

SUMMARY CHART



Valuing Properties Impacted by a Grandfathered Use Designation

Grandfathered uses are created to accommodate current uses which no longer comply with new zoning restrictions or to assist property owners when eminent domain takings result in the current use becoming a non-conforming use. Either situation can significantly affect the property's revenue generating capacity or the economic life expectancy of its improvements and may result in redevelopment of the site to a higher and better use. Whether the impact is positive or negative depends on the nature of the non-conformity. Once again, we look to the supply/demand model to understand the market's reaction to non-conformity. Consider an existing industrial property with outside storage which fits nicely in the area. Due to zoning changes, that type of use no longer conforms to the standard. If the site in question is one of only a few locations allowing that use, demand may drive up the price a willing buyer would pay. In this case, the zoning change created a premium. Conversely, if a road expansion project reduces the existing on-site parking of a business to the extent that it is no longer sufficient to support the improvement, potential buyers may avoid the property resulting in a loss of value.

If a property is physically altered by eminent domain takings which make the improvements non-conforming, municipalities will often allow the use to continue. However, it is common to impose limitations on the length of the use by restricting or eliminating the potential to make modifications to the property, such as expanding or renovating. Many municipalities require that a property be brought back into compliance with zoning codes if renovation, repair (including storm-related repair), additions or other changes to the property equal more than 60% of the value of the improvement. Consider a 20 year old office warehouse building valued at $200,000 with a life expectancy of 50 years. Assume the owner is considering significant renovations in order to accommodate a growing business. Renovations will be in excess of $120,000 (greater than 60% of existing improvement value when land value is considered.) Further, assume the property does not have sufficient parking to meet zoning regulations. The property owner must bring the property into compliance with current zoning standards. Because site characteristics do not provide sufficient space to meet parking requirements, attempts to renovate the property will be abandoned. As a result of noncompliance limitations, the property owner suffers a loss of value. In this case, restrictions on the grandfathered use resulted in a discount to the property's value.

> *"While conditional use permits and grandfathered uses offer the potential for significant premiums, they also create the potential for higher risk and/or reduced opportunity."*

Sometimes, the opposite is true and the owner realizes a benefit from the grandfathered use designation. Recently, we valued a small meat locker/slaughter house enterprise that served local farmers and businesses. Zoning regulations have changed and this type of use is no longer allowed in the city. The property was allowed to continue operation as a grandfathered use. As a result, the subject business is the only location within the city limits permitted to conduct that business. The grandfathered use designation created a strong premium for the property due to significantly increased revenues over those in the typical retail market.

Conclusion

While conditional use permits and grandfathered uses offer the potential for significant premiums, they also create the potential for higher risk and/or reduced opportunity. When these issues present themselves, it is crucial that appraisers investigate all of the details that may influence the value. Extensive research of guide plans, redevelopment plans, comprehensive zoning plans, comparable property sales, etc. are part of the due diligence process. In addition, the appraiser must focus on the actual use and conformity as of the date of valuation. If the restrictions and permissions of C.U.P.s or grandfathered uses are overlooked or inadequately analyzed, the analysis is flawed. Basic economic principles suggest that property owners seek to reduce risk and maximize value. Buyers and sellers alike engage appraisers to assess the risks and benefits associated with potential transactions. Identifying the impact of a conditional use permit or a grandfathered use designation on market value is one part of the process of valuing a property; quantifying that impact is yet another. The appraiser is ethically required to thoroughly investigate and reveal, in his or her analyses, how the value conclusion was reached and why it is justified. VV

MARKET TRANSACTION: BUSINESS VALUATION

ABC Trucking
123 Main Street
Anytown, USA

All commercial transportation modes experience business cycles, to some degree, because demand for physical goods rises and falls with economic activity. Illustrating this trend, we have observed a general slowdown in the macro-economy in the second half of 2007, which has understandably caused a slow down in the trucking industry.

In light of the slowing economic and industry factors, firms competing in this sector and seeking to achieve growth similar to that generated in the stronger years of 2004 and 2005 now consider growth by acquisition as opposed to organic growth. With the exception of fuel surcharges, it is increasingly difficult for carriers to pass on price increases to customers. In the recent past, there was a driver shortage within the industry which made it more expensive for transport companies to recruit qualified drivers. Driver shortage is no longer a problem, due to the industry slowdown, but increasing costs have put downward pressure on earnings. As a result, we anticipate the number of mergers and acquisitions relating to the transport industry to pick up during this slower economic cycle.

This transaction involves a trucking company which was acquired by another carrier within the industry. Presented below are the salient details of the transaction. As can be seen, the acquisition target had revenues of roughly $16 million; however it was not generating any profit. Despite this fact, the company was still an attractive target because of its drivers (both employees and owner-operators), equipment, and customers in place. The deal value was about $6 million for these assets. This translates to a price to revenue multiple of 38% and a price to assets multiple of 2.0.

As a note, most of the value paid for the acquired company was allocated to equipment such as tractors and trailers. There was some goodwill or intangible component of the deal value that was paid for the company's drivers in place, its name, and its customer list, among other items. The acquired company's lack of profitability was not a major deterrent for the acquiring company due to the belief that, post-acquisition, the company would become profitable under its new management.

	Trailing 12 Months (in millions)
Total Revenue	$16.1
Pre-Tax Income (Loss)	−$0.1
Book Value of Assets	$2.9
Deal Value	$6.0
Deal Value to Revenue	37.6%
Deal Value to Assets	2.0

MARKET TRANSACTION: REAL ESTATE

Property:	Vacant downtown land ripe for development
Buyer:	Minneapolis Ventures LLC (Buyer owns balance of the block.)
Seller:	Orpheum LLC
Source:	Buyer and seller
Sale Date:	October 25, 2007
Sale Price:	$10,140,480
Unit Price:	$139.29 (Does not include demolition costs or remediation.)
Zoning:	B4S-1, Downtown Service District
Utilities:	All available
Topography and Soil:	Level and sound
Visibility and Access:	Good
Land Size:	72,802 square feet
Remarks:	The buyer is currently using the site for interim parking. The proposed project would include either a hotel or over 300 units of multi-family rental units with the developer in talks with a grocery store for the first floor and Best Buy for the second floor. There is also an outside possibility of the project being developed as an office building with a major downtown tenant. The former gas station building was demolished and there is residual (slight) pollution.

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Shenehon Company is a Real Estate and Business Valuation firm, serving both the private and public sectors throughout the United States. Our unique combination of real estate and business valuation expertise allows us to provide a wide range of services and to offer innovative solutions to difficult valuation issues. Obtaining accurate and reliable industry information and expertise should play a key role in any decision-making process, and Shenehon Company is dedicated to equipping its clients with the tools necessary to make informed and knowledgeable decisions regarding their capital investments.

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