Valuation Viewpoint

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BUY-THE-FARM LAW
OBJECTIVE MEASURE OF POWER LINE DAMAGES

BY JOHN T. SCHMICK

Introduction

Determining damages (loss in value) to real property due to a partial taking is seldom straightforward. It is particularly difficult to measure damages due to easements for high voltage transmission lines (HVTLs). The issue has been studied, debated, and written about for many years. Central to most discussions is the comparison of data from two types of property sales: those with the influence of an HVTL and those without the influence of an HVTL. Reported damages vary widely depending on differences among the properties unrelated to the HTVL easement itself: property type, data selection, and adjustments for time, shape, access, and other factors which must be considered during the appraisal process.

Minnesota's unique Buy-the-Farm law (BTF) presents us with the opportunity to study damages in a relatively controlled environment. Under Minnesota's BTF law, a power company will purchase a property, place an HTVL easement on it, and then resell the property, generally within a relatively short period of time. As a result, we have the opportunity to examine the same property before and after the placement of a high voltage transmission line. This article examines current issues surrounding the BTF law and describes a specific group of transactions representing BTF purchases and resales of HVTL-impacted property.

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MARKET TRENDS AND INDICATORS

Office Buildings	→	0.0%
Retail Centers	↑	2.0%
Industrial Buildings	↑	2.0%
Apartments	↑	4.0%
New Housing Starts—Midwest	↑	4.0%
Productivity	↓	0.5%
US Unemployment	↓	7.6%
Composite PE	↑	23.6
Consumer Confidence Index	↑	81.4

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MARKET TRENDS AND INDICATORS

ECONOMIC INDICATOR

	2007	2008	2009	2010	2011	2012	MAY 2013
New Housing Starts—Midwest Yearly Totals	211,700	137,700	97,600	103,500	102,700	132,000	57,800

P/E RATIOS IN SELECT INDUSTRIES

Industry (Year end)	2006	2007	2008	2009	2010	2011	2012	2Q 2013
Basic Materials	13.7	14.1	15.2	21.6	27.4	19.7	12.6	17.7
Conglomerates	20.1	18.4	15.8	10.7	15.0	16.9	15.2	14.3
Consumer Goods	25.8	24.4	16.3	15.9	24.9	21.1	20.1	20.9
Financials	14.3	13.7	11.7	9.6	36.2	17.9	12.5	17.2
Healthcare	38.8	40.0	26.0	57.7	26.1	18.9	21.5	28.5
Industrial Goods	25.1	19.5	19.5	20.3	23.5	17.9	13.3	27.0
Services	25.6	28.7	24.2	20.1	26.6	27.1	20.1	23.1
Technology	26.3	38.4	23.8	16.4	45.2	20.2	18.1	39.5
Utilities	24.0	20.0	15.3	12.0	28.5	16.2	15.5	23.9
Composite	**24.4**	**24.0**	**18.7**	**20.5**	**28.2**	**19.5**	**16.5**	**23.6**

ECONOMIC INDICATORS

Indicator (5 yr. avg.)	2005	2010	2011	2012	MAY 2013
Inflation	3.4%	1.6%	3.1%	2.1%	1.2%
Productivity	1.8%	1.5%	.8%	1.9%	.5%
GDP	3.1%	3.0%	1.7%	2.2%	1.8%
Consumer Confidence	107.2	62.0	70.8	72.2	81.4

UNEMPLOYMENT

	1990	1995	2000	2005	2010	2011	2012	APR 2013
US	**5.4%**	**5.6%**	**4.0%**	**5.3%**	**9.4%**	**8.5%**	**7.8%**	**7.6%**
Northeast	5.0%	6.0%	4.0%	4.9%	8.4%	8.0%	8.1%	7.6%
Midwest	5.7%	4.5%	3.5%	5.7%	8.7%	7.9%	7.2%	7.2%
South	5.4%	5.4%	4.0%	5.2%	9.3%	8.4%	7.3%	7.1%
West	5.1%	6.6%	4.6%	5.5%	11.0%	8.5%	8.6%	8.0%
Minnesota	**4.6%**	**3.6%**	**2.9%**	**4.5%**	**7.0%**	**5.7%**	**5.4%**	**5.3%**

RATES OF RETURN AND RISK HIERARCHY

Investment	
30 Year Treasury	3.52%
Aaa Bond	4.32%
Commercial Mortgage	4.5–5.5%
Bbb Bond	5.35%
Institutional Real Estate	5.5–6.5%
Non-Institutional Real Estate	7–9.0%

Investment	
Equipment Finance Rates	9.0–11.0%
S & P Equity (Ibbotson)	10.0%
Speculative Real Estate	10.0–15.0%
NYSE/OTC Equity (Ibbotson)	13.8%
Land Development	15.0–30.0%
NYSE Sm Cap. Equity (Ibbotson)	21.6%

Sources: Appraisal Institute, Business Week, Value Line, U.S. Chamber of Commerce, Standard & Poors, Investment Dealers Digest, U.S. Government Census, Yahoo Finance, Bureau of Labor Statistics, Ibbotson Associates, and PwC Real Estate Investor Survey.

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INFLATION

YOUR WALLET AND THE OVERALL ECONOMY

BY JASON VETTER

Inflation is defined as the rate at which the general level of prices paid for goods and services rises over a period of time. Rising inflation means the cost of goods and services has increased, which leaves the consumer with less purchasing power because every dollar spent will purchase a smaller percentage of a good or service.

In the United States, the Federal Open Market Committee (FOMC) sets the Federal Reserve Bank monetary policies and, by extension, heavily influences inflation rates. A January 2012 Monetary Policy Release by the Federal Reserve Board of Governors stated that maintaining "inflation at the rate of 2.0 percent, as measured by the annual change in the price index for personal consumption expenditures (PCE), is most consistent over the longer run with the Federal Reserve's statutory mandate."

> *"Rising inflation means the cost of goods and services has increased, which leaves the consumer with less purchasing power because every dollar spent will purchase a smaller percentage of a good or service."*

The latest data indicates that annual inflation over the past 12 months, based on the Personal Consumption Expenditures (PCE) price index excluding food and energy, has fallen to a three and a half year low of 1.0% as of April 2013. Including food and energy, which tend to have extremely volatile prices, annual inflation was even lower at 0.74%. If low inflation means lower price increases and greater purchasing power per dollar, wouldn't such an environment be one we should strive to maintain? Why does the Federal Reserve target 2.0 percent? While low inflation may allow consumers to purchase more goods with their dollars, all things equal, the effects of inflation extend far beyond the consumer's wallet.

Recently, some Federal Reserve officials have expressed concern over these low levels of inflation and believe that if they continue, drastic measures may be necessary. Five reasons why low levels of inflation could be damaging to the overall economy are discussed below.

1. Businesses have less power to increase prices. As a result, they have less ability to pass higher costs onto the consumer, which makes them more likely to maintain profits via cost-cutting measures. As a result, the private sector could see a cutback in hiring or more employee lay-offs.
2. In this low inflation environment that is expected to continue, consumers are not as motivated to rush out and spend in order to avoid paying higher prices in the future. This hurts consumer spending, which is the largest component of the United States Gross Domestic Product.
3. Furthermore, in a low inflation environment, the economy has only a small buffer against deflation risk should an unexpected economic shock, such as a sharp decline in consumer confidence, occur. An event of this nature can dampen economic activity and lead to an oversupply of both goods and labor in the market. The result may be a slowing of inflation or even cause deflation until spending recovers and the economy returns to target employment levels. In contrast to inflation, deflation is defined as a period of falling prices. Taking our previous point one step further, if prices are expected to fall, why would consumers buy now if they can get the products cheaper still in the future? This situation also reduces consumer spending.

4. Low inflation reduces wage and revenue growth. This is an all encompassing point from the previous three points. Reduced consumer spending leads to falling corporate revenues and profits, which may force companies to reduce their own spending through wage, hiring, and employment cuts. The result: lower personal income levels and further declines in consumer spending.
5. In a low inflation environment, the FOMC has fewer options to stimulate the economy. Looking back, we see the Federal Reserve cut interest rates to zero in late 2008 in the midst of financial crisis. When that plan failed to jumpstart the recovery, the Fed launched several bond-buying programs to increase the country's money supply. This initiative has come to be known as quantitative easing. Since that time, it is estimated that the Federal Reserve has bought more than $2.5 trillion in bonds to stimulate the economy and raise employment levels. With inflation still low, amidst rock bottom interest rates and extensive bond-buying, many are concerned that the Federal Reserve is running out of tools to stimulate the economy.

> *"As the preceding commentary illustrates, economic activity very much follows a circular flow in which inflation affects not only consumers but the public and private sectors at all levels of an economy."*

While inflation reduces the value of money in consumers' wallets, the Federal Reserve realizes that it is better for our economy to experience moderate inflation versus none at all. Its mandate to target inflation at 2.0% is above current interest rate levels, and should, in theory, provide incentive for consumers and businesses to borrow and spend, thus boosting economic activity. However, the incentive is not there in a low or no inflation environment because interest rates can't fall below zero. As the preceding commentary illustrates, economic activity very much follows a circular flow in which inflation affects not only consumers but the public and private sectors at all levels of an economy.

> *"Given forecasts for weak domestic and global growth over the next several months, with inflation likely to remain below target levels, we feel it is unlikely the Federal Reserve will slow its bond-buying program through the end of the year."*

How will current conditions influence Federal Reserve policy actions? Rumors are swirling that the Federal Reserve may scale back its level of bond-buying in the summer as the economy improves. However, 42 forecasters surveyed by the Federal Reserve Bank of Philadelphia expect real GDP to grow by only 2.0% in 2013. In addition, the global economy remains tepid, with Europe continuing to battle tough economic conditions and growth in China weakening. The latest FOMC Minutes, released on May 22, 2013, report that "with longer-run inflation expectations assumed to remain stable, energy prices expected to continue to trend down, and significant resource slack persisting over the forecast period, the staff continued to project that inflation would remain subdued through 2015." Given forecasts for weak domestic and global growth over the next several months, with inflation likely to remain below target levels, we feel it is unlikely the Federal Reserve will slow its bond-buying program through the end of the year. VV

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* This article is based on publicly released data as of mid-June 2013

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What is the Buy-the-Farm Law?

Minnesota's 'Buy-the-Farm' (BTF) law is a state statute, originally enacted in 1973, requiring electric utility companies using eminent domain to purchase any amount of contiguous commercially viable land the land owner designates should he/she choose not to live with an HTVL easement on the property. This option is unusual because the electric utility company normally purchases only easement rights; the BTF law requires a purchase in fee simple interest. Minnesota's BTF law grants the property owner a one-time buy-out option whereby the power company must purchase the property and pay market value to acquire it. The Minnesota Supreme Court, commenting on a predecessor (original) statute (116C.63, subd. 4), stated:

> *The statute defines such acquisitions to be for a public purpose. In this manner, the legislature affords landowners not wishing to be adjacent to such right-of-ways the opportunity to obtain expeditiously the fair market value of their property and go elsewhere. The statute, in so doing, responds to parties most affected by the operation of high voltage transmission lines; the statute eases the difficulties of relocating by shifting the transaction cost of locating a willing purchaser for the burdened property from the land owner to the utility.*[1]

Formally known as Minnesota Statute 216E.12 (Electric Power Facility Permits: Eminent Domain Powers; Power of Condemnation) in Subdivision 4 (Contiguous land) - renumbered in 2006), the BTF law includes the following provisions:

- Property type limited to "... agricultural and nonagricultural homesteads, non-homestead agricultural land, rental residential property and both commercial and non-commercial seasonal residential recreational property...;"
- New power line must be 200 KV or larger;
- Election to use this option is one-time only, must be in writing, and must be within 60 days of notice of petition filing; and
- Land must be contiguous to the easement area and the land taken must be a 'commercially viable' unit.

Near the end of the 2013 Minnesota legislative session, changes were enacted to Section 216E.12 that provided more guidance in procedures for BTF options. These include:

- The utility company has 60 days after notice of the owner's intent to exercise the BTF option to file a written objection;
- Within 120 days of the utility company's objection, the District Court shall hold a hearing on the objection (utility company has the burden of proof); and
- Within 120 days after the Court's overruling the objection, the utility company must amend the condemnation petition and make a written offer to the property owner.

> "*Minnesota's unique Buy-the-Farm law (BTF) presents us with the opportunity to study damages in a relatively controlled environment.*"

In addition to the changes noted above, on May 29, 2013, the Minnesota Supreme Court handed down a decision related to the BTF law. The issue before the court was whether or not relocation benefits and minimum compensation statutes apply to property owners who elect the BTF option. A previous Appellate Court ruling decided they did not apply but the Minnesota Supreme Court overruled, stating all provisions of Minnesota's Eminent Domain Statutes applied under the BTF option.

1 Cooperative Power Ass'n. ex rel. Bd. Of Dirs. V. Assand, 288 N.W, 2d 697, 698 (Minn. 1980).

Evidence of Damage

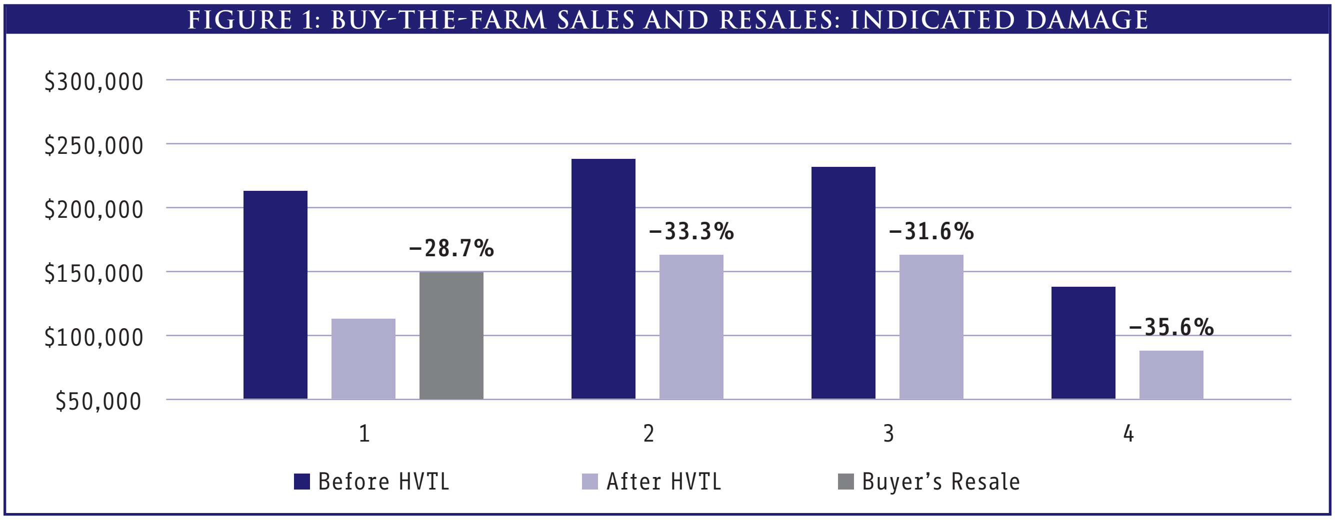
Minnesota's eminent domain law requires that the condemning authority provide the property owner with an appraisal at the time an official offer is made. The appraisal report is the basis for making a good faith deposit with the District Court for estimated damages caused by the condemnation. Typically the report is prepared by an independent appraiser hired by the condemner. The appraiser generally certifies that no project or pre-project influence is considered in the before-taking valuation analysis and conclusion. Thus, the appraisal tendered with the original offer to purchase an easement generally provides the property owner an opinion of market value for the entire property before the taking as well as an opinion of estimated damages due to a partial taking of property for the power line easement. Minnesota law also provides for partial reimbursement of appraisal fees so that a property owner is in a position to obtain his/her own independent appraisal report. In effect, Minnesota attempts to ensure that the property owner and condemning party are on equal footing at the start of the eminent domain process. Minnesota law also requires that the condemner negotiate in good faith before taking the owner's property.

> *"Minnesota's BTF law grants the property owner a one-time buy-out option whereby the power company must purchase the property and pay market value to acquire it."*

In the past two years, a new 345 KV HVTL has been under construction in Minnesota. The project, known as the CapX2020 Project, is underwritten by a consortium of power companies. We identified several single family homes purchased by the CapX2020 group under the BTF option. Original purchase prices for the properties ranged from $140,000 to $240,000 with a mean of $206,000. All four were purchased between October 2010 and April 2011. Construction dates ranged from 1984 to 2007. The power company resold the properties between November 2011 and March 2012; the average length of time the power company held a property was just over 10 months. Between the purchase date and the resale date, the power company placed an HVTL easement on the property and, in some cases, started construction of the HVTL.

Figure 1 draws attention to the impact an HVTL has on property values at the time of taking. In each case, the power company purchased the property

FIGURE 1: BUY-THE-FARM SALES AND RESALES: INDICATED DAMAGE



based on an independent appraisal and negotiations with the owner. After placing an HVTL easement on the property, the power company listed it with an independent real estate broker and resold it. As a result, the only substantive difference between the purchase and resale, other than time, is the presence of the easement. If a significant amount of time has elapsed between the purchase and resale dates, a time adjustment may be necessary to account for market changes.

Sales data suggests a loss in value from placement of a new HVTL on the property averaging -32.3 percent. In the case of sale #1, the property was purchased from the power company and resold by the new owner a short time later. We have substituted the buyer's re-sale price for the power company's re-sale price which brings the loss in value more in line with the other properties.

A spokesperson for the CapX2020 Project recently discussed BTF transactions from one section of the project. Of the 45 requests for BTF buyouts in the northern segment of the project from Fargo, ND to Monticello, MN, 30 were accepted and 15 were rejected. Of the accepted requests, only 18 purchases were completed by mid-February 2013.[2] The four purchases and matching re-sales presented in Figure 1 represent 22.2 percent of 18 BTF transactions completed for the Fargo to Monticello segment up to mid-February 2013.

> *"Land must be contiguous to the easement area and the land taken must be a 'commercially viable' unit."*

Current Issue

Although the basics are described above, this law is quite complex and the terminology confusing. One of the conditions to be met when applying for BTF is that the land must be commercially viable. However, the courts have yet to fully address and define commercially viable. In common practice, attorneys for both property owners and the power company have generally agreed it means a marketable unit. For example, if the owner-designated BTF area results in farm buildings being separated from each other, this does not necessarily produce a non-commercially viable unit. However, designating a parcel of land which has no access may, in fact, result in the loss of a commercially viable unit. It bears repeating that both parties to the taking must come to an agreement about the land size and its configuration before any transaction takes place.

> *"Minnesota attempts to ensure that the property owner and condemning party are on equal footing at the start of the eminent domain process."*

What constitutes a commercially viable property is often case-specific, with the involved parties disagreeing more often than not. Common reasons cited by power companies for objecting to the BTF property designated by the property owner include:

- Different tax parcels not included in the area of the HVTL easement;
- Property not contiguous (split by a road);
- Different ownership of parcels (mother/father/son for farm field vs. mother/father for homestead);

2 Minneapolis Star Tribune, February 13, 2013, *'Buy the Farm' law not working, Minnesota landowner says.*

- Reasonableness issues (size too large relative to the easement area or no residence on site).

Under the 2013 changes to the law, each objection to the owner's designation of property to be included in the BTF option will require a District Court hearing. At this point in time, a court-approved definition of 'commercially viable' remains elusive and the few guidelines we have offer little practical direction.

Conclusion

Construction of a new 345 KV HVTL in Minnesota provides a unique opportunity to objectively measure the impact on value caused by that power line. Under Minnesota's BTF law, certain property owners can elect to sell their entire property to the power company rather than continue to live near an HVTL. Procedures already in place ensure a reasonably fair process of determining market value prior to acquisition of the property.

> *"Minnesota's BTF law essentially shifts the risk of loss in property value from the property owner to the condemning power company."*

Ultimately, the question to be answered in any eminent domain taking case is: what is the relationship between the before taking value and the after taking value? Under the BTF statute, the power company purchases the property, places an easement/power line on the property, and re-sells the property. While some adjustment to sale prices may be considered, the difference between the acquisition price and the re-sale price of that same property, in a short time period, is an accurate and objective reflection of the loss in value faced by many property owners subject to eminent domain action to take property for an HVTL.

Minnesota's BTF law essentially shifts the risk of loss in property value from the property owner to the condemning power company. The loss of value suffered by the power company as a result of the placement of an HVTL on BTF option property should be no different from the loss of value suffered by a property owner who does not elect the BTF option. In some respects, the BTF law forces the power company to recognize a market based, objective measure of damages caused by an HVTL developed with the assistance of their own independent valuation and broker professionals.

While the BTF law provides some protection for qualified property owners, the law itself lacks depth and definition. It lacks depth in that it applies only to power line projects above 200 KV and to certain types of property. It lacks definition because certain terms and conditions are not fully described. These issues, and others, are beyond the scope of this article.

The matched pairs analysis and discussion presented in this article are not intended to provide a definitive answer to the question of how we measure damages caused by an HVTL. Rather, they are meant to illustrate that actual damages caused by an HVTL may be greater that most people believe. Ultimately, additional research and analysis on Minnesota's BTF transactions will shed even more light on the subject. A broader base of transactions would provide more support for relying on the matched pair analysis method to indicate damages. The initial indication from BTF transactions is that an HVTL causes substantial damages, but more study and discussion from those with an interest in the subject is required. VV

MARKET TRANSACTION: BUSINESS VALUATION

Zep, Inc. Completes Acquisition of Ecolab's Vehicle Care Division

On December 3, 2012, Zep, Inc (NYSE: ZEP), a producer for a wide range of cleaning and maintenance solutions, announced that it completed the purchase of St. Paul, MN-based Ecolab, Inc.'s (NYSE: ECL) Vehicle Care division for approximately $116.9 million. This acquisition will be combined with Zep's existing North American sales and service vehicle-wash operations and its Niagara and Washtronics fleet-wash operations to create a new platform, "Zep Vehicle Care." The new platform is estimated to represent 13.0% of the company's total sales.

After giving consideration to acquisition-related costs, Zep believes this purchase will be modestly accretive to earnings during fiscal 2013. When an acquisition is said to be "accretive to earnings," it means that the acquiring company could immediately realize higher earnings per share upon completing the acquisition, even after accounting for all transaction costs. Furthermore, once integration activities are complete, Zep anticipates realizing additional synergies ranging from $1.5 to $2.0 million annually.

On March 6, 2013, Zep announced that it completed the first phase of its Vehicle Care integration, including alignment of sales forces, completion of an independent valuation, and the filing of pro-forma financial statements. Zep, Inc.'s CEO, John Morgan, said "I'm pleased to report that the integration is on-track and we continue to expect modest EPS accretion in fiscal 2013 and $0.08-$0.10 EPS accretion in fiscal 2014." The company also estimated that this acquisition will give it a 10.0% market share of the vehicle wash industry, a 20.0% share in the full-service car wash area, and a 35.0% share in convenience store chains.

This isn't Zep's only acquisition in recent years. Rather, it marks the company's seventh since 2010. These acquisitions contributed to the company's revenue growth from $501.0 million in fiscal 2009 to over $653.5 million as of fiscal 2012. Over that time period, the company has reported more than $16.0 million in restructuring, merger, and acquisition expenses related to its earlier acquisitions.

Zep, Inc. completed the asset purchase for $116.9 million, which included working capital and intangibles but no property, plant, or equipment. The company used its existing debt capacity to fund the transaction, and management expects that the division's strong cash flow characteristics will allow for quick deleveraging.

The transaction's revenue and EBITDA multiples of 1.77x and 12.9x, respectively, appear reasonable considering the strong performance of Ecolab's Vehicle Care division. The division reported a net profit margin and return on equity (ROE) of 7.8% and 18.0%, respectively, in the year ended September 30, 2012. Both are above average compared to publicly traded peers in the cleaning products industry. According to Yahoo! Finance, as of the most recent quarter ended March 31, 2013, the

ECOLAB'S VEHICLE CARE DIVISION

FINANCIAL INFORMATION AS OF SEPTEMBER 30, 2012

Revenue	$65,926
Gross Profit	$33,449
EBITDA	$9,064
EBIT	$7,719
Net Income	$5,155
Total Assets	$40,398
Stockholder's Equity	$28,564
Book Value of Invested Capital	$33,532

**Trailing 12 month data presented in thousands (000s)*

TRANSACTION MULTIPLES

MVIC/Sales	1.77x
MVIC/Gross Profit	3.5x
MVIC/EBITDA	12.9x
MVIC/EBIT	15.06x
MVIC/Book Value of Invested Capital	3.49x

**All data provided by Pratt's Stats transaction database* peer group reported an average net margin and ROE of 7.0% and 13.3%, respectively.

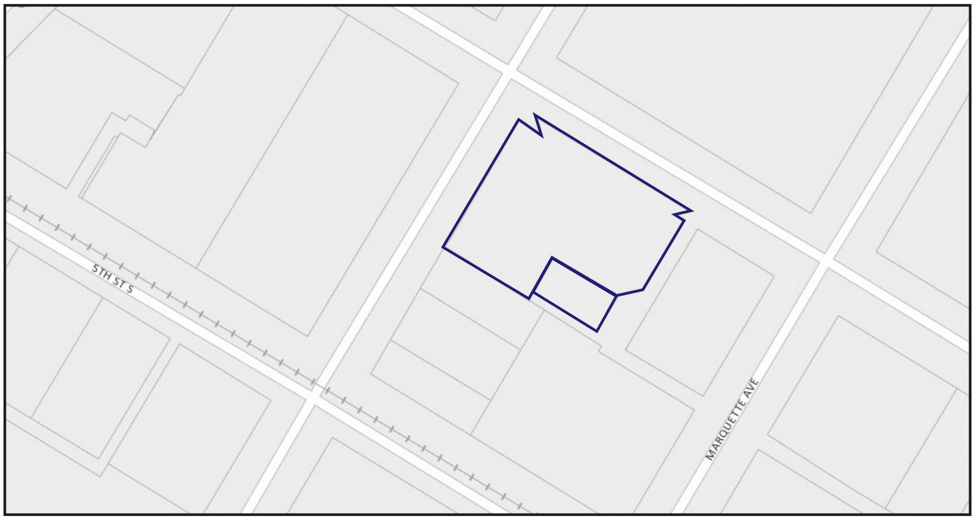
Integrating this acquisition with its existing operations will increase the strength of Zep's brand portfolio and is projected to expand the company's EBITDA margin by over 0.5%. Ecolab also signed a transition services agreement to continue to provide certain services for a period up to 12 months.

This is an important acquisition for Zep, Inc. as it restructured the company's vehicle care platform and further established Zep as an industry leader in the vehicle care and maintenance market. This segment will play a key role in achieving management's long-term strategy of growing revenues to over $1.0 billion within the next five years and surpassing its return on invested capital (ROIC) target of 15.0%. VV

CURRENT ZEP, INC. VEHICLE CARE BRANDS

ACQUIRED ECOLAB VEHICLE CARE BRANDS

MARKET TRANSACTION: REAL ESTATE



Property:	Xcel Energy Headquarters Site Assemblage 401 Nicollet Mall and 47 4th Street North Minneapolis, Minnesota 55401
Buyer:	GDSX, LLC
Sellers:	Baker Investments Partnership, I, LLC – Sale 1 RP Land, LLC – Sale 2
Source:	Public records
Sale Dates:	Sale 1 - October 14, 2012 Sale 2 - October 31, 2012
Sale Prices:	Sale 1 - $7,200,000 ($233.99 per square foot) Sale 2 - $ 500,000 ($129.33 per square foot)
Total Sale Price:	$7,700,000 ($216.58 per square foot—includes vacated alley)
Zoning:	B4-2
Utilities:	Available
Topography and Soil:	Level and assumed stable
Visibility and Access:	Excellent
Total assemblage:	35,553 square feet (includes two sites plus vacated alley)
Remarks:	GDSX, LLC purchased these sites to accommodate a build-to-suit Class A office for Xcel Energy's Headquarters. The proposed project features a 222,879-square foot building. Demolition costs, not yet available to the public, are expected to be significant. Land costs per square foot of building (density) were $34.55 plus demolition costs. Of historic interest, the smaller of these lots includes a loading dock for the former Powers Department Store. Because Powers did not have room for an on-site loading dock, freight elevators carried merchandise down one level to a subterranean storage area below the parking ramp and under the alley. Demolition costs will include removal of the elevator shaft and underground storage.

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- Tax increment financing
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