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**Property Tax Appraisals
and the Reuse of Inner-City Properties**

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Abstract

This research analyzes a sample of inner-city properties in Greensboro, North Carolina, in order to compare their market value to their appraised value for real property tax purposes. The paper seeks to understand why discrepancies arise and to explain in particular why property owners would tolerate overvalued tax appraisals. The larger question addressed is how existing use influences the redevelopment potential of inner-city properties.

The research leads to two conclusions about redevelopment in Greensboro. First, overvaluations for tax purposes are infrequent and do not represent a systematic problem. Second, the discrepancies between ask price and bid price primarily arise from different intended uses of the site and different opinions on the proper timing of redevelopment. The influence of land values and the resulting incentive to redevelop are weakest for improved sites located in older inner-city commercial areas. Reasonable tax appraisals, coupled with stricter code enforcement and other similar actions, may encourage redevelopment.

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Property Tax Appraisals and the Reuse of Inner-City Properties

I. The Redevelopment Context

The interest in revitalization and redevelopment of the central cities, older suburbs, and urban neighborhoods in the U.S. is extensive among political leaders, urban professionals, real estate developers, neighborhood advocates, business representatives, and concerned citizens. Many believe that metropolitan areas cannot sustain long-term growth without relatively vibrant or at least stable core areas. Edge cities notwithstanding, central cities are said to fulfill unique and important economic functions in the finance, legal, and business service sectors as well as providing governmental, civic, entertainment, or cultural functions for the entire metropolitan area.

Others are interested because inner-city neighborhoods are the places where low-wealth individuals and families live. Employment and earnings opportunities, as well as services, can be increased with more commercial development in these areas.

For the past three decades, core areas that have older building stock have experienced absolute decline. Almost all central cities and inner-city areas have lost ground to their adjacent suburban and fringe areas when measured in terms of their relative shares of population and employment. Reinforcing private and public investments have responded to the dominance of the automobile and the growing affluence of higher income groups and have generated the decentralized, low-density development pattern typical of most U.S. metropolitan areas that have grown primarily since the 1950s.

Many factors combine to make suburban greenfield development more attractive than inner-city redevelopment. In most instances, the returns that private developers expect adjusted for perceived differences in risk, make greenfield development projects the clear choice. Special public incentives and assistance programs are usually needed to coax private investment into inner-city areas, especially for commercial redevelopment. Beyond the frequently mentioned problems of relatively low demand for many goods and services and possible discrimination in mortgage lending, inner-city areas often suffer site-specific problems. These include environmental contamination, obsolete, unattractive or dangerous improvements that are costly to remove, and inefficient lot sizes or arrangements.

Local public policy is often inconsistent. Certain public policies and programs encourage central area commercial and neighborhood revitalization and target assistance to these areas. Yet water, sewer, roads, and other physical infrastructure are readily provided to support greenfield development while equivalent public investment is rarely provided for parking, traffic control, security, site improvements, or other infrastructure needed in central areas that already have the necessary roads, water, and sewers.

This research examines the role that the appraisal process may play in the development choice process with a study of Greensboro, North Carolina (Exhibit I). Real estate developers and investors scan urban areas for commercial development opportunities. They continually compare estimated cost to expected value for various sites in the urban area. It appears that the redevelopment of inner-city commercial properties may be thwarted because asking prices of properties considered prime for redevelopment are considerably higher than the amount real estate developers and investors are willing to offer for them. The spread between ask price and bid price may be exacerbated by the tax value placed on these commercial properties. In these situations, policies and programs designed to promote inner-city redevelopment and the property-tax appraisal process may be working at cross purposes.

This research begins by reviewing the tax appraisal process in Guilford County, North Carolina. This review indicates that discrepancies between tax value and market value should be minimal for the large majority of properties. Discrepancies that exist should primarily be undervaluations—tax value below market value. Overvaluations may also exist, primarily on commercial properties in the inner-city areas (Exhibit II); the objective and subjective reasons are discussed in the third section. The results of the empirical analysis of inner-city commercial properties are presented in the fourth section while the implications of the study for urban redevelopment are found in the fifth and final section.

II. The Tax Appraisal Process

This research was initially stimulated by the analysis of one strategic site in Greensboro, North Carolina prime for redevelopment and considered important to the revitalization of the entire East Market Street corridor. This corridor was the center of Greensboro's African-American business community before urban renewal and is now the location for retail, office and institutional land uses (primarily churches, one college and one university). The 2.5-acre site, referred to as the "Cumberland" site (see Exhibit II), provides an entranceway to downtown and contains a 33,000 SF strip retail center with several active retail uses (night club, beauty shop, record store, and sandwich shop) and an abandoned 17,000 SF grocery store. The comparison of value to the cost of redevelopment justifies a residual value of less than \$500,000 for the property.

In 1995, several developers approached the absentee landowner with an offer to purchase the Cumberland site. The highest bid price approached \$500,000. The landowner would not consider any offer of less than \$600,000 for the property, presumably because the owner's estimate of current use value or anticipated sales price were more than this amount.¹

Guilford County tax assessors seek to appraise all properties at fair market value. Statutory revaluation must occur at least every eight years in North Carolina. The most recent revaluation in the Greensboro area proceeded throughout 1995 to establish tax assessments for about 164,000 parcels effective on January 1, 1996. The new tax value placed on the Cumberland property was \$770,000.

Assessment Process

The Guilford County tax assessors office enjoys an excellent reputation as one of the best offices in the state. The staff is extremely competent and experienced, uses state-of-the art mass appraisal methods, and is not unduly exposed to political pressure.

The objectives of the property assessment are 1) to place fair values on properties and 2) to value properties efficiently. While fee appraisals of commercial properties may cost upwards from \$500, mass appraisals cost much less, even when additional staff time is involved. The average cost for all properties in Guilford County is about \$10 per parcel. To fulfill the two assessment objectives of fairness and efficiency, it is essential for the tax assessors to include the property owner in the valuation process. This is accomplished by inviting property owners to respond to informal notification of appraised value.

The mass appraisal process works well for residential properties which comprise almost 85 percent of all properties in Guilford County. The tax office devotes considerable effort to appraise the remaining income-producing properties. The staff specializes by property type (apartments, retail, fast food, office, warehouse and industrial) and, to some extent,

by geographic area.

For income-producing properties, the three approaches to valuation are used to arrive at appraised values. The tax office sends every commercial property owner an income-expense form in order to apply the income capitalization approach. Few forms are returned, however. Furthermore, comparable sales vary considerably for different areas of the county. Inner-city sales are the least frequent because these areas attract the least amount of development and investment activity. The sales that do occur are more unique than in fringe areas where vacant land and sites prime for development are more plentiful and comparable. Finally, inner-city properties are much older than average and therefore suffer more economic and functional obsolescence. Accurate estimation of value loss due to obsolescence is the most difficult task in using the cost approach.

The tax office notifies property owners with an initial unofficial estimate of appraised value and invites them to provide evidence if they disagree with the valuation. Some property owners reply, and often the tax office adjusts values on the basis of compelling factual information provided by property owners. Owners of commercial properties usually offer income and expense information and, sometimes, comparable sales or leasing information to influence the valuation.

Next, property owners receive an official notice of appraised value. Few formal appeals are filed because the prior informal process works well. Commercial property owners are most likely to file appeals in this phase of the process, and some appeals are approved. A California-based example of the appeal process is in Spiegel and Berton 1995. Overall, the mass appraisal process works rather well to meet the two primary objectives of tax assessment. Tax assessors target fair market value. Yet values considered fair by property owners may not represent values that are reasonable from the (re)development perspective.

Tax assessors claim to aim at fair market value. This target enables them to maximize tax base value and avoid revenue losses.² Others argue that they try to come within 95-97% of market value. Slight under-valuation is highly efficient because it reduces the probability of appeals. Very modest undervaluation does not harm the local jurisdiction because of the way tax revenues are raised. The jurisdiction first approves a budget and then sets a tax rate that generates the required revenue from the current tax base. A slightly undervalued tax base leads to slightly higher tax rates; most tax payers have an equivalent tax burden either way.

Appraised values, then, are likely to form a normal distribution centered slightly below true market values. Property owner participation in the valuation process tends to reduce the variation but primarily by appealing appraised values at the upper end of the distribution. With the exception of a few property owners seeking higher valuations to secure more mortgage financing,³ the large majority of appellants are trying to lower their

assessment. Thus, overvaluations tend to be adjusted downwards while undervaluations remain unchallenged. Over time, appraised values would tend to lag market values as a result. Values would not be marked to market when the property was sold and the tax assessors office qualified the sale. The property and all others would be reappraised at the next revaluation.

Appraisal Principles

Real property appraisals are supposed to reflect the highest and best use of the property, which recognizes the physical, legal, financial, and economic influences on expected use. Standards Rule 1-3 in the Uniform Standards of Professional Appraisal Practice, 1997 Edition spells out this requirement. State statutes that govern assessment practice refer to the need to appraise property at market value and to relate that value to highest and best use. In this way, Rule 1-3 becomes relevant in tax assessment. The physical attributes of the site, current or anticipated zoning, and other legal constraints eliminate most possible uses. For the remaining potential uses, financial feasibility depends on market demand sufficient to attract investment. Existing and perceived market factors ultimately determine the highest and best use of the site.

Vacant sites are valued to reflect highest and best use; improved sites reflect their current productivity. For improved sites, appraisers estimate total value but may apportion value to the improvements and to the site in several ways. One method used is to estimate the value of the improved property in its current use and to estimate the land and improvements portions separately, drawing on any or all of the three approaches to valuation. Another method involves estimating the property's current use value and the value of the site in its highest and best use. The difference between these values is assigned to the improvements.

Appraised values and market values should be relatively close for well-performing commercial properties in active markets where comparable sales exist. Well-performing properties are more likely to be put to their highest and best use or at least to highly productive uses. Although good performance may or may not result in higher tax appraisals than poor performance, owners of well-performing properties have a clear incentive to appeal tax valuations that are out of line. (Reasons why owners of poorly performing properties may be less likely to appeal are discussed in the next section.) They can increase NOI and property value if they are able to lower real property taxes. For these reasons, the tax value of commercial property should generally be near or slightly below market value. This outcome is expected to hold primarily for newer commercial development in active, fringe areas. Overvaluation should be more prevalent in central areas where older, less productive property is more likely to be found.

III. Reasons for Overvaluation

The first question is: how could the tax appraisal process lead to the overvaluation of

certain inner-city commercial properties? The second question is: why do property owners of overvalued inner-city property accept the appraisal rather than appeal?

Potential for Overvaluation

The first question can be answered by focusing on the scope and quality of information available to the tax assessment office conducting mass appraisals. Older commercial properties that are performing poorly in comparison to newer suburban properties pose difficult appraisal problems. Assume that two similar neighboring parcels exist in a transitional area. One is a vacant site; the other parcel has improvements. The sites should be valued in their highest and best use as conditioned by demand, zoning and market trends. The parcel without improvements should be simply assigned the land value that would support the most productive improvements. For the parcel with improvements, its value is based on current use, which may be lower than the value based on highest and best use.

The tax assessor should first estimate the use value of the improved parcel. The site should be assigned the value of its highest and best use, which would be the same as the value of the neighboring vacant site. The difference between the overall value of the current use and the land value as if vacant should be assigned to the improvements. As redevelopment potential increases, the positive difference between overall value and land value should approach zero. Overall value in current use may drop below land value such that the value of improvements becomes negative when the site is prime for redevelopment.

When improvements on sites in transitional areas approach negative market value, tax assessors are unlikely to assign negative values to the improvements for several reasons. First, they usually do not have good information on income and expenses. Thus, they have little confidence in values derived from the income capitalization approach. They must rely on limited sales information and seek opinions from local MAIs about property and land values in the area.

Second, they have very few comparable sales. The sales that do occur may have upwardly biased prices for three reasons: 1) the sale is more likely to occur in a stronger inner-city sub-market area, 2) the property may be in better condition than the average property in the inner-city area,⁴ or 3) the buyer may have overpaid either due to inexperience or politics. In this instance, the private owner may be reluctant to provide information on poor property performance. Thus, the market approach may generate less accurate and possibly upwardly biased values compared to outcomes in more active markets.

Third, the cost approach is most flexible and defensible because the most readily available information pertains to construction costs and the physical condition of the improvements. Tax assessors estimate depreciation with information on market and

physical factors.⁵ Unfortunately, the parcel's land value plus its depreciated replacement cost may not be adequately constrained by value estimated from the perspective of future cash flows (income capitalization).

Tax assessors are well aware of these problems, which exist for a small number of commercial parcels in transitional areas. When market value is difficult to discover and income-expense information is not provided, they seek a solution that property owners will accept as fair in order to keep the appraisal process efficient. They assign the land value that roughly reflects highest and best use and a value to improvements that deducts deterioration and obsolescence from replacement cost. Although their first concern is to approximate fair market value for these properties, assessors are quite concerned about achieving valuations that are consistent between neighboring properties and within the same sub-areas. With an approach that addresses consistency, improvements will always have positive value reflective of current use. The tax value for one parcel may be above, at, or below market value. As noted, tax assessors must rely on property owners to flag appraisals that are out of line.⁶

Acceptance of Overvaluations

Property owners of less productive properties in transitional areas have the normal incentives to appeal overvaluations but may not do so for the three reasons: 1) acceptable current income, 2) increased wealth position, and 3) anticipated capital gains from appreciation. First, these property owners are often satisfied with cash flows when they are sufficient to generate acceptable profits. They rarely invest in the property, preferring to get what cash they can from the property as is. They may accept an inflated tax value because their assessment is consistent with others in their area. Furthermore, they may anticipate a public initiative that requires the use of eminent domain. Whether true or not, they feel that they can claim the tax value as a basis of compensation under condemnation rather than the property's lower market value. On the other hand, sophisticated buyers tend to commission appraisals or at least consult with local MAIs. In these instances, tax value should have little influence on the transaction.

Second, these property owners may own many commercial properties in the locality or in other urban areas; they may be absentee owners. Overvalued properties increase their wealth position. Often, these property owners rely on the strength of their balance sheet in order to engage in real estate activities. Moreover, property owners may get psychic satisfaction out of appraised values that make them appear to be wealthier than they are. Third, overvaluation may not have onerous financial consequences, at least not in growing urban areas where tax rates are relatively low. Commercial property owners can forego current income in order to improve their chances to secure higher capital gains from property sales, especially when they expect to sell in the near future. Moreover, when increased tax values result from statutory reappraisals, the tax burden on real property does not necessarily increase.⁷ Tax rates are often lowered when the overall tax

base is reappraised at considerably higher value. The current real estate tax rate in Greensboro is 1.256% of market value. The 1995 tax rate before reappraisal was 1.4248% of market value.

In declining central cities, on the other hand, the effective tax rate may be quite high. Property abandonment is common in some of these central cities due to the vicious cycle of economic decline, smaller tax base, higher social costs, and increasing tax rates, which result in much less tolerance for overvaluations. Abandonment provides clear empirical evidence that either tax value exceeds market value for these properties or the tax rate results in real estate taxes which reduce or eliminate positive market value. Property owners owing property taxes have the same implicit put option as borrowers who may default on mortgage loans when the outstanding principal balance is greater than the market value of the property or when debt service exceeds cash inflow.

Urban Economic Conditions

The legacy of earlier market conditions in core areas may represent another factor that upwardly biases recent appraisals. During the 1980s, many central business districts experienced considerable office development. In these central areas, trophy properties were constructed in the most attractive locations. Such development and redevelopment justified relatively high land values. In contrast, the remaining properties may have inferior locations, improvements, or site attributes. Appraisers are well aware of state statutes and Standards Rule 1-3 a) that requires taking market demand into account when estimating value. Yet thin recent sales may make downward adjustments less supportable, especially for land values. In Greensboro, land values on the tax records of commercial properties in the central areas range from about \$12-\$35 per SF. Prime retail or office property outside the central area rarely costs more than \$5-\$6 per SF.⁸

More generally, market trends are more difficult to read in inner-city areas. As noted, public policies often work at cross-purposes, some encouraging, others discouraging new investment. The private sector often has different views on future possibilities. Some developers and investors see little potential and no need for attention to core-area redevelopment. Others are optimistic about the future of core areas. These inconsistencies may lead to greater variation in sales prices or estimates of value.⁹

IV. Analysis of Commercial Property

This research focused on properties in retail use and, to a lesser extent, office use and residential use to determine how frequently appraised values for tax purposes exceed the market values of commercial properties in Greensboro, North Carolina. The tax record for one property not included in the analysis is presented in Appendix A. Note that, by statute, no information on income or expenses is permitted on the tax record, even if provided by the property owner.

Research Methods

An initial set of about 70 parcels was examined to compare valuations in different parts of Greensboro. As expected, tax value and market value both for vacant land and developed commercial properties were fairly consistent in the developing fringe areas. Forty-five properties were selected for further analysis and were located in three sub-areas of the inner-city: the old central business district (South Elm Street), an area to the northwest of the traditional high-rent corner at Market and Elm Streets that is considered more attractive to new investment, and an area along East Market Street that is considered less attractive for private investment and where the Cumberland site is located. Exhibit II shows these three areas.

Local tax assessors and real estate experts were consulted to examine information on 1) the physical and economic attributes of the properties, and 2) the property tax records and tax values placed on these properties. Recent photographs of each property were used to facilitate the analysis. Examples are in Appendix B. The tax assessors were asked to explain the appraisal process used to value these properties and to comment on selected value estimates. Local real estate professionals were asked to estimate the market values of each property. The eight local experts included three developers, one commercial broker, one appraiser, one real estate attorney, one property manager, and one property owner. A modified Delphi process was used to converge on the market value estimates and to solicit insights about redevelopment potential.

Results

The results of the analysis are reported for 38 properties in Exhibit III. The market values were estimated primarily using the income capitalization approach. In addition, information on recent sales was used whenever possible. Current market values were adjusted to be consistent with the tax valuations that were effective January 1, 1996. The three approaches to valuation were used by the tax assessment office to establish values, as explained above.

Of the 38 parcels, 15 are in the old central business district primarily along South Elm Street, 14 are west of this downtown area on North Greene Street and other streets in this area, and 9 are on the east side primarily along East Market Street. Properties with tax value below 90 percent of estimated market value are considered undervalued for tax purposes. Properties with tax value above 105 percent of estimated market value are considered overvalued. Properties are considered to be valued at market when tax value is within 15 percent of estimated market value (90%-105%).

The CBD parcels are either undervalued or near market value; no parcels appear to be overvalued. The parcels to the west of downtown are overvalued in two instances and

undervalued or at market for the remaining 12 properties. Three parcels on the east side are overvalued while the remaining six are at market. Overall 21% of all parcels are undervalued, 66% are at or near market value, and 13% are overvalued for tax purposes.

The results indicate that appraised values are reasonably close to estimated market values in most instances, notwithstanding the difficulties of appraising these properties accurately. The most accurate estimates are in the most active and attractive sub-area west of downtown. Undervaluations downtown may reflect recent optimism and interest resulting in higher values there compared to historical sales levels. Overall, undervaluations occur more frequently than overvaluations. The results clearly show that overvaluation is not a systematic problem in the inner-city areas of Greensboro. The five properties that appear to be overvalued were examined on a case-by-case basis to understand why overvaluations appear to exist.

For two parcels, their market value is essentially the value of the vacant land. Inflated land values result in assessed values well above market values. The overvalued properties, as expected, are relatively large parcels where the overvaluation of land has the greatest absolute impact.

In two other cases, overvaluation appears to result from inadequate information on income and expenses. For these parcels, relatively high land values and the value placed on relatively well maintained improvements result in overall values that are not consistent with market value estimated by capitalizing expected income.

Furthermore, the market is placing values on improvements far below assessed value in a few cases where redevelopment is soon anticipated. For example, on the Cumberland site, the assessed value of the abandoned grocery store is \$122,200 while the market would probably value the store at a negative \$30,000 which is the approximate cost of demolition and removal.¹⁰

V. Inner-City Redevelopment Reconsidered

The research leads to two conclusions about redevelopment in Greensboro. First, overvaluations for tax purposes are infrequent and do not represent a systematic problem. Second, the discrepancies between ask price and bid price primarily arise from different intended uses of the site and different opinions on the proper timing of redevelopment. Developers evaluate the property's *potential* use. Property owners (and tax assessors) focus on the value that can be derived from the *current* use of the property. Developers tend to seek out rather immediate redevelopment opportunities. Property owners appear to be more patient investors, especially when current net cash flows are positive and considered adequate. Investors, be they current property owners or buyers, generally try to estimate the time when redevelopment will become most attractive.

These different perspectives are illustrated with the hypothetical alternatives shown in Exhibit IV. Case 1 A) indicates that a commercial development project on the fringe that can be pursued in the near future is worth \$1.0 million and the greenfield site is worth \$300,000. Case 2 represents the value to the current owner of a developed site devoted to an on-going commercial use in the central area. The lower value reflects the lower demand and/or higher costs in the central area compared to the fringe area. The owner should continue the existing commercial use until the site value (land value as if vacant) less the cost of demolition, which reflects a redevelopment opportunity, becomes higher than the existing use value. Case 3 represents the point when the current owner should consider selling or redeveloping the property. Note that NOI in Case 3 has to be substantially below NOI from the current use (Case 2) before redevelopment is the rational choice. Because land value is a small portion of total value for most commercial properties (usually from 10 percent to 20 percent), the use value of improvements has to decline considerably before the influence of market-based land values (land value as if vacant) can become decisive. In Exhibit IV, the current use value (Case 3) must drop to 27% of highest and best alternative use value (Case 1 A) before redevelopment is a clear option for the property owner.

The influence of land values and the resulting incentive to redevelop are weakest in older central commercial areas. Developed inner-city properties in these areas are often multiple-story buildings that do not provide on-site parking, which minimizes land area relative to the floor area of the building. Conversely, poorly performing inner-city properties that are large parcels with low-rise buildings have the most redevelopment potential. These properties are similar to newer fringe properties that have high land value-to-building value ratios because the site contains low-rise buildings and on-site parking. The correlated implication is that vacant inner-city sites are more likely to be offered at financially feasible asking prices than sites with improvements.

Case 1 B) further illustrates why the price incentives for the redevelopment of improved properties are rather weak. Although NOI from the redevelopment opportunity is more than three times the use value in Case 3, a transaction may not be realized. The figures shown for Case 1 B), as explained in the notes to Exhibit IV, are quite realistic in comparison to developing the same project on the greenfield site--Case 1 A). The combination of slightly lower NOI and slightly higher capitalization rates leads to a residual land value at or below the likely ask price of \$300,000. Furthermore, construction costs in Case 1 B) are slightly below construction costs in Case 1 A). Evidence from redevelopment projects suggests that construction costs can be higher than new development when the building is obsolete or the property is encumbered with environmental or other problems. Thus, the bid price is likely to be much closer to \$150,000 than to the ask price of \$300,000.

Case 4 presents a more intensive redevelopment project timed for five years in the future. The property owner is speculating that market-area conditions will substantially improve in the future. Stronger future demand is expected to support the Case 1 A) NOI per SF

and 25,000 SF of net leasable area. The residual land value is about \$500,000, which is approximately the land value warranted by the redevelopment project five years hence, discounted at 10 percent. In addition, the property owner will receive NOI from the property's current use for 4 more years until redeveloping the site in year 5.¹¹ Positive income from existing improvements in this case makes it more comfortable for the owner to hold onto the property. Speculating on improved property is less costly than holding vacant land that is liable for real property taxes and covered by casualty insurance. Thus, the expectation of a major turn around in the sub-area, however unrealistic,¹² puts the ask price far out of range for immediate redevelopment that reflects current market realities.

Since the incentive to redevelop provided by land appraised at market value is weakest for improved commercial properties in inner-city areas, other actions appear to be necessary to encourage redevelopment. At least in growing metropolitan areas like Greensboro, code enforcement can be effective when the property owner is neglecting the property and deferring maintenance. Tenants may also be evicted for serious violations of the law. These public actions increase expenses and vacancies and directly lower NOI. Private mortgagees can be alert to delinquencies and loan covenant violations and press for corrections when warranted. If these rather strong actions fail to encourage sales or redevelopment, eminent domain may be used to condemn the property for a public purpose. However, using the condemnation power is both time consuming and expensive.

These required actions underscore the difficulties faced by jurisdictions wanting to pursue inner-city redevelopment. Yet reasonable tax appraisals coupled with stricter enforcement may lead to more desirable public and private outcomes. The absolute and relative cost to the tax base of lower appraised values for the most marginal properties should be modest and justifiable given the benefits of redevelopment.

In conclusion, redevelopment should occur in inner-city areas where the spread between bid price and ask price is minimal. These prices will be close as long as the developer and the property owner have the same land use, intensity, and timing of development in mind. Larger vacant parcels will be especially attractive since they are most costly for current owners to hold and can support a wider range of redevelopment alternatives. They may also offer more amenities, including parking, on site. Yet, frequently, developers and property owners have different views about local market conditions and trends, which lead to different assessments of the proper use, intensity, and timing of redevelopment. Redevelopment will languish in inner-city areas where such differences of opinion exist.

Notes

1. The three sources of return from owning real estate are cash flow, appreciation, and tax benefits. Current use value is the present value of net cash inflow received in perpetuity, estimated by dividing this cash flow by the market capitalization rate. Although realizing net cash inflow in the near term, the owner may anticipate significant appreciation in the foreseeable future. The present value of the expected capital gains plus net cash flow in the interim may be the reservation price of the property owner.
2. The state allocates revenues from public utilities to counties on a pro rata basis unless the ratio of assessed value to sales prices falls below 0.90. In these cases, allocations are adjusted downward.
3. Valuations for a few other properties are raised as the result of neighbor appeals, which, again, reflect the importance of consistency and perceived fairness of the appraisal process.
4. The buyer may be a public agency able to purchase the property at a price above market value in order to convert the property to a public use. However, the appraiser would not use this transaction as a comparable sale.
5. However, reliable market information is not readily available for these properties. Economic obsolescence, locational obsolescence and, to a lesser extent, physical obsolescence are very difficult to estimate accurately. See Lusht (1997), Ch. 12.
6. Overvaluations may exist for three additional reasons: cyclical influences, the threat of appeal, and reverse discrimination. Over the property cycle, reappraisals that occur infrequently are often below market values during the upward phase and may be above market values during the downward phase. Appraisals may also not recognize value declines occurring in particular sub-areas. Second, appraisers may undervalue expensive properties and overvalue cheap properties given the probability of appeal. Owners of expensive properties may have more ability and resources to challenge their assessment compared less sophisticated and less wealthy property owners. Third, appraisers may be exercising reverse discrimination by overvaluing properties in inner-city minority areas. None of these reasons appear to apply in the Greensboro case. The revaluation that occurred in January 1996 should have adjusted appropriately for cyclical effects. The professionalism of the Guilford County staff makes biases due to racial or other political influences unlikely.
7. In fact, the burden on the real property portion increases at reappraisal because personal property is marked to market annually while real property is revalued every eight years. Thus, the burden shifts from personal property to real property in

revaluation years.

8. Parcels outside the central area are larger than central-area sites on average. Smaller developable sites have higher value per SF than larger developable sites due to the diminishing marginal utility of more land. Still, central-area land appears to be overvalued in Greensboro.
9. Greater price variation in inner-city markets also reflects higher risk to lenders and equity investors for two reasons. First, government relations may be more cumbersome in central cities compared to suburban communities. Longer permitting time, more expensive submission requirements, linkage programs, higher impact fees, etc. increase development-period risk and cost. Second, greater variation implies higher risk whether due to weaker economic fundamentals, institutional biases, or negative perceptions. As a result, private investors may use higher capitalization rates when valuing properties in these areas compared to suburban areas. In other words, the point estimate of the market-determined (direct) capitalization rate may well be lower than the investor-determined capitalization rate.
10. In general, it is not unreasonable to assign positive value to buildings that are partially or entirely vacant. Vacancy rates fluctuate, especially in retail properties; properties currently vacant may not remain vacant for long, while currently occupied properties may become vacant. Appraisers deduct expected vacancy losses from income in order to reflect local market conditions and trends.
11. The present value of realizing NOI of \$50,000 for 4 more years is almost \$16,000. The property owner would receive this amount less the debt service payments and income taxes due.
12. In the real world, such expectations are often fueled by local redevelopment initiatives. Local governments and redevelopment authorities have been known to pay “astronomical” prices for properties considered strategically important for implementing redevelopment plans.

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Expert Sources:

(Several persons requested that their name not be listed.)

Bill Benjamin (attorney)

Jimmy Black (real estate broker and investor)

Bill Campbell (attorney and professor)

Gordon Cole (appraiser)

Jenks Crayton (tax assessor)

Joe Hunt (appraiser and instructor)

Cooper James (developer)

Don Jud (real estate professor)

Tom Pearson (real estate professor and appraiser)

Michael Shiftan (developer and property manager)

Mac Sims (developer)

Al Wellmon (tax assessor)

Exhibit I

Exhibit II

Exhibit III

Estimated Market Value and Tax Appraisal Values for Inner-City Properties
in Greensboro, North Carolina for January 1996

Property Location	Undervalued	At Market	Overvalued	Total
Downtown	7	8	0	15
West Downtown	1	11	2	14
East Market Street	0	6	3	9
Total	8	25	5	38
% of Total	21%	66%	13%	100%

Exhibit IV
Redevelopment of Hypothetical Property

Case 1

A) Highest and Best Use of Greenfield Site

B) Redevelopment Opportunity

Net Operating Income/SF	\$10/SF	\$9/SF
Net Leasable Area	10,000 SF	10,000 SF
NOI	\$100,000	\$90,000
Capitalization Rate	10%	10 -12%
Market Value	\$1.0 mill.	\$750,000 - 900,000
Construction Cost/SF	\$50/SF	\$40/SF
Gross Leasable Area	12,000 SF	12,000 SF
Construction Costs	\$600,000	\$480,000
Soft Costs & Fees	\$100,000	\$120,000
Total Cost of Improvements	\$700,000	\$600,000
Residual Land Value	\$300,000	\$150,000 - 300,000
Parcel Size	30,000 SF	30,000 SF
Land Value/SF	\$10/SF	\$5 - 10/SF

Case 2

Current Use Value

Net Operating Income/SF	\$5/SF
Net Leasable Area	10,000 SF
NOI	\$50,000
Capitalization Rate	10%
Value to Owner	\$500,000

Case 3

Use Value to Trigger Sale or Redevelopment

Net Operating Income/SF	\$2.70/SF
Net Leasable Area	10,000 SF
NOI	\$27,000
Capitalization Rate	10%
Value to Owner	\$270,000
Residual Land Value	\$300,000
Parcel Size	30,000 SF
Land Value/SF	\$10/SF
Demolition Cost/SF	\$1/SF
Net Land Value	\$270,000

Case 4

Speculative Hold to Redevelop at Higher Intensity in 5 Years

Net Operating Income/SF	\$10/SF
Net Leasable Area	25,000 SF
NOI	\$250,000
Capitalization Rate	10%
Value to Owner	\$2.5 mill.
Construction Cost/SF	\$50/SF
Gross Leasable Area	30,000 SF
Construction Costs	\$1.5 mill.
Soft Costs & Fees	\$200,000
Total Cost of Improvements	\$1.7 mill.
Residual Land Value (in year 5)	\$800,000
Residual Land Value (present value)	\$500,000
Parcel Size	30,000 SF
Land Value/SF (present value)	\$16.67/SF

Exhibit IV Notes

Explanation of Case 1 B) Redevelopment Opportunity:

NOI/SF in the inner-city area is assumed to be less than in the fringe areas for the same commercial project due to either lower sales per SF (less demand), higher operating expenses (possibly due to the need for more security) or higher real estate taxes, which is likely if the greenfield site is in a suburban jurisdiction or not within the city. On the other hand, real property taxes could be reduced by 50% if the property has historic significance.

Capitalization rates are assumed to be higher primarily due to higher perceived risk in inner-city areas. Once redevelopment attains a critical mass, this risk premium should decrease and eventually disappear.

Construction costs are assumed to be lower because of usable elements from existing improvements. For example, structures, interior improvements, paved parking areas, lighting, signage, landscaping, etc. may lower redevelopment costs. Just as often, however, environmental problems (asbestos, subsurface contamination), obsolete space arrangements, unattractive finishes, and a variety of building code violations drive up the hard costs of redevelopment. Historic properties usually cost more to redevelop in order to preserve valued building features. Financial feasibility analysis performed on renovation projects in downtown Raleigh and Durham, North Carolina suggest that renovation hard costs can equal or exceed the hard costs of new construction even when compromises are reached on building code compliance. Demolition of improvements followed by new construction may be the cheaper redevelopment alternative.

Soft costs are higher either because redevelopment projects are more complex and uncertain and/or require more time for approval or for construction. In particular, professional fees, construction-period interest and contingency are expected to be higher.

Explanation of Case 4 Speculative Hold to Redevelop at Higher Intensity in 5 Years

Estimated value anticipates dramatically improved market conditions that support 25,000 SF of new space leased the same value as in Case 1 A) which generates NOI of \$10/SF.

Costs are equivalent to those in Case 1 A).

The residual land value of \$800,000 is equivalent to about \$500,000 in present value, discounted for five years at 10%.

Appendix A
Tax Record Example

Appendix B
Photographs

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