STATE OF MINNESOTA	TAX COURT REGULAR DIVISION
COUNTY OF DAKOTA	FIRST JUDICIAL DISTRICT

KCP Hastings, LLC,

Petitioner,

vs.

County of Dakota,

Respondent.

FINDINGS OF FACT, CONCLUSIONS OF LAW, AND ORDER FOR JUDGMENT

File Nos: 19HA-CV-11-2713
19HA-CV-12-2223
19HA-CV-13-1742

Filed: November 12, 2014

This matter came on for trial before The Honorable Joanne H. Turner, Judge of the Minnesota Tax Court.

Dan Biersdorf, Ryan Simatic, and E. Kelly Keady, Biersdorf & Associates, P.A., represented petitioner KCP Hastings, LLC.

Suzanne W. Schrader, Assistant Dakota County Attorney, represented respondent Dakota County.

These property tax cases concern the market value of a multi-tenant retail shopping center in Hastings, Minnesota, as of January 2, 2010, January 2, 2011, and January 2, 2012. The parties filed post-trial findings of fact and briefs, the last of which was received on August 12, 2014. We find that the assessed value of the subject property understates its market value as of all three valuation dates.

The court, having heard and considered the evidence adduced at trial, and upon all the files, records, and proceedings herein, now makes the following:

FINDINGS OF FACT

1. KCP Hastings, Inc., has sufficient interest in the property to maintain this petition; all statutory and jurisdictional requirements have been fulfilled; and the court has jurisdiction over the subject matter of the action and the parties thereto.

2. The subject property consists of approximately 11 acres of land with a street address of 1355 South Frontage Road, Hastings, Minnesota. The subject property was improved in 1976 with a 153,749 square foot[1] multi-tenant retail shopping center (129,475 square feet of net rentable area). The property is zoned C-4.

3. The highest and best use of the subject property is as it is currently improved, namely, as a multi-tenant retail shopping center.

4. The Dakota County Assessor valued the property at $4,791,600 as of January 2, 2010; $4,821,700 as of January 2, 2011; and $4,821,700 as of January 2, 2012.

5. Petitioner's appraiser, Paul G. Bakken, opined that the fee simple market value of the subject property was $3,250,000 as of January 2, 2010; $2,850,000 as of January 2, 2011; and $2,800,000 as of January 2, 2012.

6. The County's appraiser, Brian M. Ducklow, opined that the fee simple market value of the subject property was $6,684,700 as of January 2, 2010; $5,980,400 as of January 2, 2012; and $5,303,900 as of January 2, 2012.

7. The fee simple market value of the subject property as of January 2, 2010, was $5,535,000.

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1 The County's appraiser assumed 140,852 square feet of gross building area, Ex. R1, at 4; petitioner's appraiser assumed 153,749 square feet of gross building area, Ex. 1, at 26. There is no explanation in the County's appraiser's report for his calculation of gross building area. Petitioner's appraiser includes in his report a floor plan of the building, Ex. 1, at 27, from which we have verified his calculation of gross building area.

8. The fee simple market value of the subject property as of January 2, 2011, was $5,258,200.

9. The fee simple market value of the subject property as of January 2, 2012, was $4,995,300.

CONCLUSIONS OF LAW

1. Petitioner submitted sufficient credible evidence to rebut the presumptive validity of the assessed value as of each valuation date at issue.

2. The Dakota County Assessor's estimated market value for the subject property as of January 2, 2010, understates its market value as of that date.

3. The Dakota County Assessor's estimated market value for the subject property as of January 2, 2011, understates its market value as of that date.

4. The Dakota County Assessor's estimated market value for the subject property as of January 2, 2012, understates its market value as of that date.

ORDER FOR JUDGMENT

1. The County's assessed value of the subject property as of January 2, 2010, shall be increased from $4,791,600 to $5,535,700.

2. The County's assessed value of the subject property as of January 2, 2011, shall be increased from $4,821,700 to $5,258,200.

3. The County's assessed value of the subject property as of January 2, 2012, shall be decreased from $4,821,700 to $4,995,300.

4. Real estate taxes due and payable in 2011, 2012, and 2013 shall be recomputed accordingly and refunds, if any, paid to petitioner as required by such computations, together with interest from the original date of payment.

IT IS SO ORDERED. THIS IS A FINAL ORDER. A STAY OF 15 DAYS IS HEREBY ORDERED. LET JUDGMENT BE ENTERED ACCORDINGLY.

BY THE COURT:

Joanne H. Turner, Judge
MINNESOTA TAX COURT

DATED: November 12, 2014

MEMORANDUM

These property tax cases concern the market value as of January 2, 2010, January 2, 2011, and January 2, 2012, of a multi-tenant retail shopping center in Hastings, Minnesota.

A. DESCRIPTION OF THE SUBJECT PROPERTY

The subject property consists of three tax parcels, totaling approximately 11.18 acres of land, at the southeast corner of Pleasant and the south frontage road of Highway 55 (145th Street East) on the west side of Hastings, Minnesota. The subject property is south and east of the Dakota County Government Center. Several fast-food restaurants, two banks, and a gas station occupy the block north of the subject property, between the south frontage road and Highway 55 itself. An outlot of about 1.18 acres in the northwest corner of the site has been separately offered for sale for a number of years, apparently without success.

The property is improved with an L-shaped partially enclosed retail shopping center, constructed in 1976 and comprising 153,749 square feet of gross building area (129,475 square feet of net rentable area). The net rentable area includes two larger tenant suites (29,293 and 33,638 square feet, respectively) at either end of the building, leased as of the valuation dates to Goodwill and Clancy's Drug, respectively. The remainder of the net rentable area is divided into 23 smaller tenant suites, ranging in size from about 250 square feet to 10,000 square feet. Eleven of the smaller tenant suites located in the enclosed "elbow" of the building and totaling 24,882 square feet are not directly accessible from the outside. The tenant suites with direct access to the parking lot are generally 30 to 35 feet wide and from 125 to 167 feet deep. A retail gas station/convenience store at one end of the building completes the available rental suites. The balance of the site (including the outlot in the northwest corner) is a blacktopped parking lot with space for 700 cars.

Vacancy rates at the subject property increased during the years at issue. In 2010, the property was approximately 95% leased. *See* Ex. R1, at 88-89. Several large tenants (Sears, HealthSouth, and the local school district) left the center between 2009 and 2012, and by 2013 the property was only about 70% leased. Ex. R1, at 88, 109-21 (rent rolls).

B. BURDEN OF PROOF

The assessor's estimated market value is prima facie valid. *S. Minn. Beet Sugar Coop v. Cnty. of Renville*, 737 N.W.2d 545, 557 (Minn. 2007) (citing Minn. Stat. §§ 271.06, subd. 6 & 272.06 (2012)). The petitioner may overcome the presumption of validity by introducing evidence that the assessor's estimated market value is incorrect. *Id.* at 558. We conclude that KCP Hastings presented sufficient evidence through the testimony of its witnesses to rebut the presumption. When the presumption of validity is overcome, we determine the market value of the subject property based upon a preponderance of the evidence. *Macy's Retail Holdings, Inc. v. Cnty. of Hennepin*, Nos. 27-CV-07-07774 et al., 2011 WL 6117899, at *2 (Minn. T.C.

Nov. 28, 2011) (citing *Pep Boys v. Cnty. of Anoka*, Nos. C2-01-2780 et al., 2004 WL 2436350, at *3 (Minn. T.C. Oct. 26, 2004)).

C. HIGHEST AND BEST USE

In valuing real property, we consider "the use that should be made of an improved property in light of the existing improvements" and "the ideal improvement" if the property were already vacant. Appraisal Institute, *The Appraisal of Real Estate* 345 (14th ed. 2013) (sometimes "Fourteenth Edition" or "Appraisal of Real Estate"); *see id.* at 42 (noting that the purpose of analyzing the property's highest and best use is to "identif[y] the use or uses on which the final opinion of value is based"). Here, the experts agree that the highest and best use of the subject property is as it is currently improved, namely, as a multi-tenant strip shopping center. Ex. 1, at 58; Ex. R1, at 32. We concur.

D. VALUATION

We consider the three traditional approaches to valuation—cost, income, and sales comparison—in determining market value. *See Equitable Life Assur. Soc'y of U.S. v. Cnty. of Ramsey*, 530 N.W.2d 544, 552 (Minn. 1995). We are not required, however, to give weight to all three valuation approaches, and we may place greater emphasis on a particular approach or approaches. *Id.* at 554.

1. COST APPROACH

The cost approach is based upon the proposition that "an informed buyer would pay no more for the property than the cost of constructing new property having the same utility." *Id.* at 552.

The County's expert, Brian Ducklow, SAMA, applied the cost approach to the subject property, using cost estimates from Marshall Valuation Service to reach a replacement cost of the improvements of $14,112,700 as of January 2, 2010; $14,536,100 as of January 2, 2011; and $14,972,200 as of January 2, 2012. Ex. R-1, at 68.[2] Mr. Ducklow reduced these amounts by 33% for physical depreciation, using the age-life method, an estimated physical life of 45 years, and an effective age of 25 years. Ex. R-1, at 69-70 (referencing Marshall Valuation Service). Mr. Ducklow further reduced these amounts by 10% for functional obsolescence attributed to the L-shaped design of the building. Ex. R-1, at 71.[3] Finally, Mr. Ducklow reduced replacement cost by 10% (15% as of January 2, 2011, and 20% as of January 2, 2012) for external or economic obsolescence, namely, "the current softness in the market." Ex. R-1, at 71. After these reductions, and adding $2,858,400 ($255,671 per square foot) for the land itself, Mr. Ducklow's opinions of value under the cost approach were as follows:

January 2, 2010	$9,491,400
January 2, 2011	$8,963,600
January 2, 2012	$8,398,100

Ex. R-1, at 73. But Mr. Ducklow did not give much weight to the cost approach. Tr. 253-54.

Petitioner's expert, Paul Bakken, MAI, CCIM, did not apply the cost approach, "[g]iven the age of the property and the high amount of accrued depreciation." Ex. 1, at 9.

We also make no determination of market value using the cost approach. The improvements to the subject property were constructed in 1976, making cost estimates inherently

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2 As we have noted, Mr. Ducklow assumed a gross building area of 140,852 square feet. Ex. R1, at 68.

3 Elsewhere, Mr. Ducklow's appraisal describes the subject property as a "good quality commercial building with good functionality with good access and parking to the building. No functional obsolescence noted." Ex. R1, at 36. We credit the fact that Mr. Ducklow actually reduced his estimate of market value under the cost approach for functional obsolescence.

less than reliable.[4] *See Sears, Roebuck & Co. v. Cnty. of Dakota*, No. C4-04-7619 et al., 2007 WL 2481290, at *3 (Minn. T.C. Aug. 30, 2007) ("When older properties have experienced significant depreciation and obsolescence, the cost approach is not a reliable method to use to ascertain market value.").

2. SALES COMPARISON APPROACH

The sales comparison approach assumes, among other things, "that the value of property tends to be set by the cost of acquiring a substitute or alternative property of similar utility and desirability within a reasonable amount of time." *Appraisal of Real Estate* 379; *see Equitable Life Assur. Soc'y*, 530 N.W.2d at 552 (observing that the sales comparison approach "is based on prices paid in actual market transactions involving comparable properties"). Application of the sales comparison approach requires analysis of recent sales of other properties to determine the comparability of those properties to the subject property, and adjustment of their sales prices as necessary for such features as age, size, location, and condition to make those properties

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[4] We cannot reconcile Mr. Ducklow's reduction for functional obsolescence with his overall opinion of value. Mr. Ducklow used Marshall Valuation Service to estimate the replacement cost of the improvements to the subject property, assuming the same number of square feet of gross building area. Ex. R1, at 68. Mr. Ducklow then reduced the estimated replacement cost by 10% for "functional obsolescence," noting the "limited visibility" inherent in the building's L-shaped design and opining that such a footprint "would not likely be constructed due to limited site exposure." Ex. R1, at 70-71. The 10% reduction is equivalent to a reduction in the total square footage of the building from approximately 140,000 square feet (using Mr. Ducklow's figures) to approximately 126,000 square feet. But Mr. Ducklow does not explain how a building of even 126,000 square feet could be constructed on this site without also employing an L-shaped design, with all of its inherent problems. (For example, eliminating the "elbow" of the building does not appear to equate to a 10% reduction in net rentable area. There are 24,882 square feet of net rentable area in the elbow, or approximately 19% of the total net rentable area. *See* Ex. 1, at 27 (floorplan).) Nor does Mr. Ducklow's reduction of only 10% appear to account for other functional deficiencies at the subject property, such as the fact that in-line tenant spaces are narrower and deeper than current market preferences. *See* Ex. 1, at 28; Tr. 243 (Mr. Ducklow testifying that he considered the depth of in-line tenant spaces "as part of the functional obsolescence with this property").

comparable to the subject property. *Appraisal of Real Estate* 381-82. The reliability of this approach depends on the availability of sales information for other properties, and on the comparability of those properties to the subject. *Id.* at 380.

a. Petitioner's expert's approach

Petitioner's expert appraiser, Mr. Bakken, identified only one "known retail sale in Hastings during the years in question," namely, the Hastings Marketplace, which sold in September 2009. Ex. 1, at 91, 95. Concluding that Hastings Marketplace "is far superior to the subject," Mr. Bakken searched for "comparable shopping center sales which are both older properties and that also contain enclosed areas similar to the same design elements of the subject property." Ex. 1, at 95. Mr. Bakken found "no such properties" in the metro area that sold during the relevant time period, relying instead on five enclosed malls (four in Minnesota, one in North Dakota[5]) that sold between June 2008 and December 2012 at unadjusted sale prices ranging from $9.70 to $27.10 per square foot. Ex. 1, at 110.[6, 7] Mr. Bakken adjusted the sale prices to the first date of value (January 2, 2010) using the Moody's/RCA price trend index for

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5 The malls are located in Bemidji, Brainerd, Worthington, and Hutchinson, Minnesota, and in Dickinson, North Dakota. Ex. 1, at 96-107.

6 Mr. Bakken discussed a sixth property (the East Brainerd Mall) but excluded it from his final estimate of value for two reasons: (1) approximately one-third of the property is used as office, rather than retail, space; and (2) the property sold after the last date of value at issue here and as part of a portfolio of two properties. Ex. 1, at 109.

7 Mr. Bakken's calculations inconsistently mix gross building area and net rentable area. For example, page 95 of Mr. Bakken's report calculates sale price per square foot of gross building area for each of his comparable properties. Ex. 1, at 95. But the amounts to which Mr. Bakken makes adjustments for such things as location and size are a mix of price per square foot of gross building area and price per square foot of net rentable area. *Compare* Ex. 1, at 112 *with* Ex. 1, at 95. In fact, we can find the amounts labeled by Mr. Bakken as "actual price $ overall" nowhere else in his report. *Compare, e.g.*, Ex. 1, at 112 (showing "actual price $ overall" for comparable property 1 of $14.36) *with* Ex. 1, at 95, 96 (showing price per square foot for comparable property 1 of $15.95).

commercial properties in non-metropolitan areas. Ex. 1, at 108. Mr. Bakken further adjusted the sale prices for location, vacancy rate at date of sale, "economics," strength of anchor tenant(s) and duration of anchor lease(s), age and condition, size, and for unspecified miscellaneous factors.[8] Ex. 1, at 110-12. After these adjustments, the sale prices of the five comparable properties ranged from $17.00 to $22.35 per square foot, with an average of $18.59 per square foot and a median of $17.97 per square foot. Ex. 1, at 112. From this, Mr. Bakken concluded that the value of the subject property as of each valuation date was $20.00 per square foot of net rentable area, or $2,600,000 total. Ex. 1, at 111-12.[9]

We conclude that in limiting his search for comparable properties to fully enclosed shopping malls, Mr. Bakken cast his net too narrowly. By our calculation, less than 20% of the net rentable area of the subject property lacks an external entrance. *See* Ex. 1, at 27 (floor plan). Although that number is not insignificant, it is a far cry from a fully enclosed retail mall, in which only the anchor tenants are likely to have external entrances. For this reason, we have given Mr. Bakken's comparable properties little weight in our analysis.

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[8] Only the Westgate Mall in Brainerd and the subject property were adjusted for "other/miscellaneous" factors; in each case, the adjustment was upward by $0.50 per square foot. Ex. 1, at 112.

[9] As we have noted, Mr. Bakken's calculations mix gross building area and net rentable area. Had Mr. Bakken used gross building area consistently across his comparable properties, we calculate he would have arrived at an average adjusted sale price of $19.61 per square foot, for a total of $3,015,000 for the subject property (based on 153,749 square feet of gross building area).

b. The County's expert's approach

Mr. Ducklow considered six retail properties in the Twin Cities metropolitan area[10] that sold between May 2008 and January 2012 at unadjusted sale prices ranging from $43.71 to $110.14 per square foot. Ex. R1, at 76-82. Mr. Ducklow adjusted their sale prices to January 2010 at an inflation rate of -5% per year after January 2008. Ex. R1, at 83, 85. Mr. Ducklow further adjusted the sale prices for location, ease of access, visibility, size, land-to-building ratio, age, condition and quality, building "efficiency," and presence of anchor stores and tenant mix. Ex. R1, at 83. After these adjustments, the sale prices of the six comparable properties ranged from $34.69 to $54.11 per square foot. Ex. R1, at 83. Mr. Ducklow gave the greatest weight to the sale of the property on White Bear Avenue in St. Paul, arriving at an estimated market value of $41.00 per square foot ($5,744,900 total) as of January 2, 2010. Ex. R1, at 87.[11] Mr. Ducklow reduced this value by 5% to arrive at an estimated market value for the subject property of $38.95 ($5,486,200 total) as of January 2, 2011,[12] and by 10% to arrive at an estimated market value of $37.00 ($5,211,500 total) as of January 2, 2012. Ex. R1, at 87.

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10 Mr. Ducklow's comparable properties are located on White Bear Avenue in St. Paul; on Cahill Avenue and on Brodercik Boulevard in Inver Grove Heights; on Market Boulevard and on Second Street East in Hastings; and on South Robert Street in West St. Paul. Ex. R1, at 76-81.

11 Again, Mr. Ducklow assumed 140,852 square feet of gross building area. Ex. R1, at 87.

12 Mr. Ducklow's report includes two different values for 2011 under the sales comparison approach: $5,486,200 and $5,646,200. Ex. R1, at 87. Because $5,486,200 is the product of Mr. Ducklow's announced market value per square foot ($38.95) and his assumed gross building area (140,852 square feet), we credit it rather than $5,646,200.

1. Comparability

Ducklow comparable 6. Mr. Ducklow comparable property 6 is an office/retail building on Second Street East in downtown Hastings, purchased in 2011 by a local nonprofit in part for its own use. Ex. R1, at 81 (indicating that the buyer will occupy space in the property). At trial, Mr. Ducklow agreed that comparable 6 is not a community center, Tr. 241, and on that basis we give the property little weight in our analysis.

Anchor tenants. Four of Mr. Ducklow's comparable properties have as an anchor tenant a large grocery store (Cub or Rainbow). *See* Ex. R1, at 76-80. By comparison, the largest tenant spaces in the subject property are leased by Goodwill Industries and by Clancy's Drug Store. The parties disagree concerning whether either of these businesses constitutes an anchor tenant.

An anchor store has been defined as

> a major store such as a chain store or major department store that
>
> 1. Generates a high amount of retail customer traffic
> 2. Has substantial economic strength (i.e., creditworthiness)
> 3. Occupies a large space within the shopping center relative to other tenants.

Appraisal Institute, *Dictionary of Real Estate Appraisal* 8 (5th ed. 2010). Another authority explains that an anchor tenant's "expenditures for advertising to generate customer traffic to the center" justify the reduced rents typically paid by anchor tenants, compared to "tenants who pay higher rents but incur little or no advertising expenses." James D. Vernor, Michael F. Amundson, Jeffrey A. Johnson & Joseph S. Rabianski, eds., *Shopping Center Appraisal and Analysis* 21 (2009).

With these definitions in mind, we conclude there is insufficient evidence in the record before us to conclude that either Goodwill or Clancy's constitutes an anchor tenant. Even if we were to conclude that each occupies a large space in the subject property relative to other tenants, we could not say on this record that either does substantial advertising to generate customer traffic, or in fact generates a high amount of retail customer traffic from which other tenants of the subject property benefit. Nor could we say on this record that either has substantial economic strength.

Mr. Ducklow adjusted the sale prices of his four comparable properties downward by 10% to reflect, in part, the differences in mix of anchors and tenants. Ex. R1, at 83, 86. We think that adjustment too low to adequately capture the difference between the traffic generated by a full-service grocery store and either Goodwill or Clancy's, and make a downward adjustment of 20% instead.

Land-to-building ratio. Mr. Ducklow adjusted the sale price of his comparable property 3 downward by 5% for its land-to-building ratio but adjusted the sale price of his comparable property 5 downward by 10%, even though the two had virtually identical land-to-building ratios (4.95 for comparable 3; 4.96 for comparable 4). Ex. R1, at 83. We think the adjustment of comparable property 3 is a typographical error, and apply a downward adjustment of 10%.

Hastings Marketplace. Mr. Bakken contends that the sale of Hastings Marketplace in September 2009 for approximately $112.78 per square foot effectively caps the value of the subject property at $20.30 per square foot. Ex. 1, at 90. More specifically, Mr. Bakken contends that "properties like the subject will trade at a multiple of income." Ex. 1, at 90. According to Mr. Bakken, the net operating income of the subject property was about 18% of the income generated by Hastings Marketplace in 2010, from which Mr. Bakken concludes that the value of the subject property should be about 18% of the value of Hastings Marketplace. Ex. 1, at 90.

The Fourteenth Edition cautions against making income-based adjustments when applying the sales comparison approach:

> Prices of comparable properties are not usually adjusted based on differences in the net operating income per unit because rents and sale prices tend to move in relative tandem. A value indication developed using net operating income per square foot as a unit of comparison is not independent of a value indication developed using direct capitalization, which negates the checks and balances provided by using more than one approach to value. In effect, the results suffer from circular logic.

Appraisal of Real Estate 387.[13]

2. Conditions of sale

Exercise of option to buy. According to Mr. Ducklow, property number 5 was purchased by its tenant, who exercised an option to buy. Ex. R1, at 80. According to Mr. Ducklow, the buyer "paid a slight premium for the property," for which Mr. Ducklow made a downward adjustment of 10%. Ex. R1, at 85. We adopt Mr. Ducklow's adjustment.

Private sale. According to Mr. Ducklow, property number 3 was purchased at a private sale, that is, before the property was listed for sale. Ex. R1, at 78. The property was appraised for financing purposes at $6,100,000: $600,000 more than its private sale price. Ex. R1, at 78. From this, we conclude that the price used by Mr. Ducklow was likely less than market value due to the lack of broker commissions. For this reason, we use the appraised value.

Purchase from foreclosure. Mr. Ducklow's property number 1 is a retail strip center in St. Paul. The sale on which Mr. Ducklow relies is a 2012 purchase from the bank that foreclosed

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[13] *See also* James D. Vernor, Michael F. Amundson, Jeffrey A. Johnson & Joseph S. Rabianski, *Shopping Center Appraisal and Analysis* 179 (2d ed. 2009) ("Some appraisers think that significant information is conveyed in the sales comparison approach by analyzing the ratio of NOI per square foot of [gross leasable area] for the comparable sales and inferring the results to the subject property. A mathematical demonstration can show that this ratio is the reciprocal of the capitalization rate and that its use compromises the independence of the sales comparison and income approaches.").

its mortgage on the property in 2010. Ex. R1, at 76. The price for which "property would sell at a forced sale" is not to be considered. *See* Minn. Stat. § 273.11, subd. 1 (2012). Because considerations other than price—such as regulatory limits on the amount of property the bank could carry on its books—may have affected the bank's decision to sell, we have given no weight to sales out of foreclosure. *See Johnson v. Cnty. of Chisago*, No. 13-CV-10-499, 2012 WL 516823, at *5 (Minn. T.C. Feb. 14, 2012) (declining to consider the price paid for a foreclosed property at a bank auction to be an arm's-length price because "the bank may have been under pressure to move the property off its books" and citing the bank's need "to convert a foreclosed property into a performing asset"). The circumstances of this sale, however, persuade us that it was not forced. In particular, according to Mr. Ducklow, the bank held the property for two years, during which time the bank worked to lease the property. *See* Ex. R1, at 76 (indicating that after foreclosing in 2010, the bank signed a long-term lease at the property with a local nonprofit thrift store). This indicates to us the bank's lack of need to sell the property quickly and its desire to maximize the selling price, both indicators of an arm's-length sale.

Making the indicated adjustments, we reach the following adjusted sales prices for the five comparable properties:

Comparable property 1	$40.86
Comparable property 2	$35.40
Comparable property 3	$24.08
Comparable property 4	$32.38
Comparable property 5	$32.16

Like Mr. Ducklow, we consider property 1 on White Bear Avenue in St. Paul the most comparable to the subject property. Like the subject property, it has no traditional department store or grocery store anchor. Rather, its largest tenants are ARC Value Village (comparable to Goodwill, one of the largest tenants at the subject property) and Midway Training. Ex. R1, at 76.

Its gross building area (116,673 square feet) is smaller than the subject, but only Ducklow's property 5 is larger. *See* Ex. R1, at 76. We therefore give property 1 a weighting of 50%, and the other four properties roughly equal weight. Applying these weights, we arrive at an estimated market value for the subject property of $36.00 per square foot of gross building area, for a total market value under the sales comparison approach of $5,535,000 as of January 2, 2010. We reduce this amount by 5% as of January 2, 2011 ($5,258,200) and by another 5% as of January 2, 2012 ($4,995,300). *See* Ex. R1, at 87.

3. INCOME APPROACH

The income approach to value is based on the present value of future rights to income generated by a property, determined by capitalizing anticipated rents generated by the property at market rates, less expenses of the property at market rates. *Macy's Retail Holdings,* 2011 WL 6117899, at *9 (citing *Space Ctr. Enters., Inc. v. Cnty. of Ramsey*, Nos. C4-97-3360 et al., 1999 WL 1018098 (Minn. T.C. Nov. 4, 1999)).

At the outset, the parties' experts approached the valuation problem from different perspectives. Mr. Bakken estimated value under the income approach using a discounted cash flow technique, reasoning that given forecast occupancy levels, "the subject property has not achieved stabilized operations." Ex. 1, at 60. To employ the discounted cash flow technique, Mr. Bakken estimated market rents for each category of space at the subject property. Ex. 1, at 85, 87. Mr. Bakken estimated losses due to vacancy and turnover, relying on expiration dates of leases actually in place at the subject property. Ex. 1, at 83-84. Mr. Bakken also estimated expenditures for tenant improvements and leasing commissions, again relying on the expiration of leases actually in place at the subject property. Ex. 1, at 83-84. After subtracting operating expenses and reserves for structural expenses, Mr. Bakken arrived at annual cash flows before debt service and taxes, to which he applied a discount factor and to which he added a lump sum reflecting the sale of the property at the end of 10 years to arrive at his final estimate of market value. Ex. 1, at 84-88. Mr. Ducklow estimated value under the income approach using a direct capitalization technique, but used different market rents and vacancy rates for each date of valuation. Ex. R1, at 96. Each party contends that the other's approach is flawed.

"Direct capitalization is a method used in the income capitalization approach to convert a single year's income expectancy into a value indication." *Appraisal of Real Estate* 491. The approach "is widely used when properties are already operating on a stabilized basis." *Id.* "The direct capitalization methodology may be less useful for properties going through an initial lease-up period and for properties with income or expenses that are expected to change in an irregular pattern over time." *Id.* Indeed, direct capitalization "does not directly consider individual cash flows beyond one year." *Id.* at 492.

In this case, Mr. Ducklow applied the direct capitalization approach as of each valuation date, thereby converting "a single year's income expectancy into a value indication," but using different market rents and vacancy rates as of each valuation date. Ex. R1, at 94-96. The direct capitalization approach used by Mr. Ducklow necessarily assumes that a potential buyer of the subject property would have forecasted on each valuation date that market rents, vacancy rates, and operating expenses for the subject property were stable.[14] In other words, Mr. Ducklow's calculations necessarily assume for example that as of January 2, 2010, a prospective buyer of the subject property would have expected the property to generate $738,769 (Mr. Ducklow's estimate, *see* Ex. R1, at 95) in total rental revenues, not just in 2010 but for the foreseeable

[14] Or are forecast to change consistently over time at rates that can be captured in the applicable discount rate.

future. Similarly, Mr. Ducklow's calculations necessarily assume that as of January 2, 2010, a potential buyer of the subject property would have expected to lose 10% (Mr. Ducklow's estimate, *see* Ex. R1, at 96) of that potential revenue to vacancies and collection losses, not just in 2010 but for the foreseeable future.

The evidence in the record before us—indeed, the evidence in Mr. Ducklow's own report—does not support such assumptions. To the contrary, the record indicates not only that market rents for the subject property were declining during the years at issue, but that on each valuation date, market rents were expected to decline further. Similarly, the record indicates not only that market vacancy rates for community and neighborhood centers like the subject property were increasing during the years at issue, but that on each valuation date, vacancy rates were expected to increase further.

As of a January 2010 analysis by NorthMarq cited by Mr. Ducklow, there was nearly 2.3 million square feet of vacant retail space in community shopping centers in the Twin Cities. Ex. R1, at 24. At the same time, according to NorthMarq, "many retailers' sales are down, and they do not have the capital to support a relocation." Ex. R1, at 24. "Because of the abundance of space and lack of active retailers," NorthMarq wrote, "landlords are faced with rate reductions virtually across the board," with overall net effective rates down 20-30% from their peak. Ex. R1, at 25. According to the 2010 NorthMarq report, "[t]here is no competition" for space in community centers. Ex. R1, at 24. "No community centers are under construction," according to NorthMarq, and "[p]lans for more than 25 centers, totaling 9.7 million square feet, have been downgraded from 'planned' status to 'preliminary' until the market begins to rebound." Ex. R1, at 25.

The January 2011 NorthMarq report saw only a slight reduction in the vacancy rate at community shopping centers, with most of that improvement coming at community centers that (unlike the subject property) were "anchored by big-box, category-dominant retailers." Ex. R1, at 26. Indeed, NorthMarq concluded, "[t]he best centers are seeing a majority of the activity, so *the strong centers are becoming stronger and the weak are becoming weaker*." Ex. R1, at 28 (emphasis added). The January 2012 NorthMarq report concluded that vacancy rates increased during 2011. Ex. R1, at 29. According to NorthMarq, having "selected the [vacant big] boxes they wanted in prime trade areas at favorable rates," retailers "may take a step back and look at their sales before opening more stores," Ex. R1, at 31, indicating that vacancy rates (even at centers with big-box retail space to lease) were likely to remain high. With respect to market rents, NorthMarq indicated: "Many landlords do not have pricing power yet. Landlords may be getting tenants to pay market rates, but they are investing significantly more up front in tenant improvements and build-outs than they were pre-recession." Ex. R1, at 31. In addition, according to NorthMarq, some 923,000 square feet of additional space in community retail centers was under construction, but that was "driven by a handful of big-box users." Ex. R1, at 30.

Based on this record, we conclude that a direct capitalization approach was not appropriate here. A prospective buyer of the subject property could not reasonably have concluded that on any of the valuation dates, market rents or vacancy rates were stable. We therefore place little weight on the market values determined by Mr. Ducklow using the direct capitalization approach.

In contrast to the direct capitalization approach, discounted cash flow analysis "explicitly calculates the year-by-year effects of potentially changing income patterns, changes in the original investment's value, and other considerations." *Appraisal of Real Estate* 492. The discounted cash flow approach employed by petitioner's expert, Mr. Bakken, is specifically designed to capture the effects on market value of expected changes in such things as market rents and market vacancy levels.

The County contends that Mr. Bakken's discounted cash flow approach fails to capture a fee simple value because it relies on actual, rather than market, amounts for some of its inputs. Respondent's Post-Trial Br. 21. For example, Mr. Bakken relies on actual expiration dates of the leases currently in place at the subject property, rather than market vacancy rates, to estimate losses due to turnover and vacancy and to forecast the need for future expenditures for tenant improvements and leasing commissions. Ex. 1, at 83-84.

In *Equitable Life Assurance Society of the United States v. County of Ramsey*, we arrived at market value by applying a discounted cash flow analysis on the assumption that a prospective purchaser of the subject property would do the same: "A prospective purchaser would be a sophisticated investor who would project the cash flow and the capital requirements of the Property during the ownership period." Nos. C8-91-6247 et al., 1993 WL 377210, at * 3 (Minn. T.C. Sept. 24, 1993). The Minnesota Supreme Court affirmed. *Equitable Life Assur. Soc. of U.S. v. Cnty. of Ramsey*, 530 N.W.2d 544, 547 (Minn. 1995). The supreme court rejected Ramsey County's argument that our discounted cash flow analysis "improperly determined the investment value of the subject property as opposed to its market value." *Id.* at 555. Rather, the court noted, "value, to a large extent, is created in the minds of individuals who constitute a market." *Id.* The record established that "the likely universe of prospective purchasers of the subject property" was "institutional investors or large development companies," and the petitioner's expert's discounted cash flow analysis (on which we had relied, to some extent) had been prepared "with that likely market in mind, incorporating the investment criteria held by such entities." *Id.*

Similarly, we conclude in this case that a discounted cash flow analysis represents one approach by which prospective buyers and sellers of the subject property would evaluate the subject property as an investment. The record in this case indicates that the most likely buyer for the subject property on the valuation dates at issue was an individual investor, rather than a pension fund or real estate investment trust. Tr. 16-17, 18-20.[15] The record further indicates that a prospective individual buyer of the subject property would have been required to present a rent roll and historical financial information to lenders to obtain financing. Tr. 35. Presumably, lenders would have evaluated the property for lending purposes based on its projected cash flows. Finally, the record indicates that in arriving at a listing price, a broker would have prepared a discounted cash flow analysis, taking into consideration the probability that current tenants would renew existing leases and, to the extent they do not, forecasting expenditures for tenant improvements and leasing commissions needed to re-lease the space. Tr. 27-29.

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15 At trial, petitioner presented testimony of Robert Pounds, a consultant associated with Colliers International in the Twin Cities, that the subject property would not be of interest to institutional investors, limiting the universe of prospective buyers for the subject property to private investors. Tr. 17, 19.

At the same time, Mr. Pounds testified, "it would have been very challenging for a private investor to get a loan to buy this property" during the time frame at issue. Tr. 36. Indeed, Mr. Pounds testified it would have been "very unlikely" that a broker "could produce a sale price" acceptable to the owner of the property. Tr. 36. The point of Mr. Pounds' testimony appears to have been that the market value of the subject property on these valuation dates was nil or, at least, that even the market values to which petitioner's expert appraiser, Paul Bakken, opined "were too high." Tr. 41. But Mr. Pounds offered no opinions of market value of his own. Tr. 64 (Pounds testifying that he is neither a licensed real estate appraiser nor a licensed real estate broker). In reaching our conclusions of market value, we have given this aspect of Mr. Pounds' testimony little weight.

Although a discounted cash flow approach is appropriate here, we conclude that we cannot rely on the discounted cash flow analysis performed by Mr. Bakken. We are unable to replicate Mr. Bakken's calculations of base rental revenue, losses due to absorption and turnover vacancy, CAM charges, losses due to "general vacancy," expenditures for tenant improvements, or expenditures for leasing commissions.[16] Indeed, at trial Mr. Bakken conceded that verification of his calculations required "a schedule that [the court doesn't] have" and which apparently was not produced to the County either. Tr. 168-69.[17] Because we cannot replicate Mr. Bakken's discounted cash flow analysis, we give it no weight.

E. FINAL VALUES

On the basis of the sales comparison approach to value, we conclude that the market value of the subject property is as follows:

January 2, 2010	$5,535,000
January 2, 2011	$5,258,200
January 2, 2012	$4,995,300

J.H.T.

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16 For example, Mr. Bakken testified at trial that he assumed annual increases of 3% in "both income and expenses." Tr. 169. But Mr. Bakken's discounted cash flow statements do not appear to incorporate 3% increases, at least in rent revenues. Between 2010 and 2013, for example, Mr. Bakken's assumed potential gross income is essentially flat. *See* Ex. 1, at 84.

17 Mr. Bakken testified at trial that his discounted cash flow spreadsheet was not produced to the County because it was not "asked for." Tr. 167. The scheduling order issued in this case explicitly required "disclosure of the facts or data underlying the appraiser's opinion either as part of the written appraisal or as a separate document or collection of documents." Order ¶ 5 (Sept. 9, 2013); *see* Minn. R. Evid. 705. Petitioner offered to introduce Mr. Bakken's worksheets during rebuttal; the offer coming only on rebuttal, we sustained the County's objection to the exhibits on the basis of unfair surprise. Tr. 313-16.