STATE OF MINNESOTA	TAX COURT
	FOURTH JUDICIAL DISTRICT
COUNTY OF HENNEPIN	REGULAR DIVISION

Northwestern National Life Insurance Company,	FINDINGS OF FACT, CONCLUSIONS OF LAW AND ORDER FOR JUDGMENT
Petitioner,	
vs.	File No. TC-18794
County of Hennepin,	
Respondent.	Dated: June 21, 1995

This matter was heard by the Honorable Kathleen Doar, Chief Judge of the Minnesota Tax Court, from December 13 to December 20, 1994, at the Hennepin County District Court facilities in the Minneapolis City Hall, in Minneapolis, Minnesota.

Thomas R. Wilhelmy, Attorney at Law, represented the Petitioner.

Marilyn Maloney, Assistant Hennepin County Attorney, appeared for the Respondent.

The issue in this case is the January 2, 1992 fair market value of property located at 111 Washington Avenue South in Minneapolis.

Post-trial briefs were filed by both parties and the matter was submitted to the Court for decision on March 2, 1995.

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

FINDINGS OF FACT

1. Petitioner has sufficient interest in the property to maintain this petition; all statutory and jurisdictional requirements have been complied with, and the Court has jurisdiction over the subject matter of the action and the parties hereto.

2. The subject property is located at 111 Washington Avenue South at the intersection of Washington Avenue South and Marquette Avenue (the "Property"). Its property identification number is 23-029-24-33-0001.

3. The Property is approximately five blocks north of the core of the Minneapolis Business District which is located at Seventh Avenue South and Marquette Avenue and six blocks north of the core of the Minneapolis Retail District located at Seventh Avenue South and Nicollet Avenue.

4. The Property is improved with a mid-rise, office-data center constructed in 1987 by Northwestern National Life Insurance Company ("Northwestern National Life") at a cost of approximately $42,000,000. It includes fifteen stories above ground and two levels below ground. There is no on-site parking.

5. The building is connected to the Minneapolis skyway system.

6. The building was fully occupied by Northwestern National Life for three years. On January 2, 1992 it was in good condition and approximately 50% owner-occupied, 30% tenant occupied and 20% vacant.

7. Four new Class A, multi-tenant office towers opened in the Minneapolis Business District during 1990 and 1991, adding 2.9 million square feet of office space to the market. They are: (1) the Dain Bosworth Plaza, a 40-story office tower located

on Nicollet between Fifth and Sixth Streets; (2) First Bank Place, a 1.3 million square foot development located between Sixth and Seventh Streets and Second and Third Avenues; (3) The A T & T Tower, a 34-story office building located at the corner of Marquette and Ninth Street; and (4) La Salle Plaza, a 1.4 million square foot development located between Hennepin and La Salle and Eighth and Ninth Streets.

8. The Minneapolis multi-tenant office market was oversupplied in 1992 causing increased vacancies and decreased rents.

9. The assessor placed an estimated market value of $29,500,000 on the Property on the January 2, 1992 assessment date.

10. Dennis W. Jabs, MAI, of Dennis W. Jabs & Associates, Inc. testified for Petitioner. Mr. Jabs considered the cost and market approaches to value but relied upon a discounted cash flow income approach to support his January 2, 1992 opinion of value of $15,000,000.

11. Daniel T. Boris, SRPA, of the Minneapolis Assessor's Office, testified for Respondent. Mr. Boris utilized the cost, market and income approaches to value but relied primarily upon a discounted cash flow income approach to support his January 2, 1992 opinion of value of $28,500,000.

12. The Court finds the January 2, 1992 market value of the Property to be $19,600,000.

CONCLUSIONS OF LAW

1. The assessor's estimated market value for the Property as of January 2, 1992 shall be reduced on the books and records of Hennepin County from $29,500,000 to

$19,600,000.

2. Real estate taxes due and payable in 1993 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.

LET JUDGMENT BE ENTERED ACCORDINGLY. THIS IS A FINAL ORDER. A STAY OF 15 DAYS IS HEREBY ORDERED. BY THE COURT,

____
Kathleen Doar, Chief Judge
MINNESOTA TAX COURT

DATED: June 21, 1995

MEMORANDUM

The subject property (the "Property") is located at the intersection of Washington Avenue South and Marquette Avenue, approximately five blocks from the core of the Minneapolis Business District. It is improved with a mid-rise, office-data center built in 1987. The fifteen-story building faces North on Washington Avenue and is connected to the Minneapolis skyway system (the skyway system does not pass through the building however). On the January 2, 1992 assessment date the building was in good condition and 50% occupied by its owner, Northwestern National Life Insurance Company ("Northwestern National Life"), 30% leased and 20% vacant.

Four new Class A, multi-tenant office towers opened in the Minneapolis Business District between 1990 and 1992 adding 2.9 million square feet of office space to the market. The addition of this space increased vacancies and decreased rents in 1992. The issue is what effect this oversupply of space had on the market value of the Property on January 2, 1992.

Five witnesses testified at trial. Dennis W. Jabs, MAI, testified as an expert witness for Petitioner and Daniel T. Boris, SRPA, testified as an expert for Respondent. Mr. James E. Jachymowski, the Northwestern National Life employee responsible for leasing the Property, testified as a fact witness. Each party called one additional appraisal witness to review portions of the appraisal submitted by the opposing expert. Richard A. Stimmler, SAMA, Supervisor of Real Estate Assessments for the City of Minneapolis, testified for Respondent and Maxwell O. Ramsland, Jr., MAI, CRE, ASA of Ramsland & Vigen, Inc., testified for Petitioner. Neither Mr. Stimmler nor Mr. Ramsland offered an opinion of January 2, 1992 market value.

Mr. Jabs considered but did not perform a cost or a market approach and relied entirely upon a discounted cash flow income ("DCF") approach to value to support his final opinion of January 2, 1992 value of $15,000,000. Mr. Boris performed cost, market, direct capitalization and DCF approaches to reach his January 2, 1992 opinion of value of $28,500,000.

Market Approach.

Mr. Jabs testified that: (1) a lack of market activity on or around the assessment date rendered the market approach unreliable; and (2) an income-producing property market approach requires a careful analysis of comparable property leases because the purchaser of an office building subject to lease buys the income stream produced by leases in place. He did not perform a market approach because reliable comparable property lease information was not available to him.

Mr. Boris testified that the universe of comparable sales was indeed small and

that there are "no good comparables out there." He performed a market approach however, adjusting the sale price of thirteen properties for physical differences between the comparable and the Property, for conditions of sale, for time and for interest sold (i.e., condo, leased fee or fee simple). We have reviewed Mr. Boris' market approach and find that none of the sales listed in Mr. Boris' appraisal was an arms-length, open-market sale.[1] Additionally, supporting evidence regarding comparable property lease terms was unavailable to Mr. Boris. We find the market approach unreliable here.[2]

Income Approach.

Mr. Boris performed a direct capitalization approach and both appraisers performed a DCF income approach. Both agreed that the oversupply of space and consequent market instability rendered the direct capitalization approach, which assumes a stable income stream, less reliable.

The appraisers disagreed on three appraisal issues. First, Mr. Jabs used effective net rent[3] in his DCF so that the expenses of tenant improvements and leasing costs were deducted before he entered any data in his DCF. Mr. Boris used net rent[4]

---

[1]. Many of the properties were distressed at the time of sale, several were purchased by captive purchasers and at least two "sales" did not close.

[2]. We admitted evidence of the November 1994 sale of the La Salle Plaza, which was not contained in Mr. Boris' written report, over Petitioner's objection because Mr. Boris was unaware of the sale when he prepared the report. He acknowledged on cross-examination, however, that he believed the La Salle property was subject to an above-market, long-term lease and that information regarding this sale was not verified.

[3]. Net effective rent is net rent per square foot calculated as gross rent less operating expense and real estate tax, less amortized tenant improvements and leasing costs.

[4]. Net rent is gross rent less operating expense and real estate tax before any deduction for amortized tenant improvements and leasing commissions.

and deducted the cost of tenant improvement and leasing costs as DCF expenses. We assume that if accurate market data is used, annual cash flow figures will be the same with either method. We use Mr. Boris' net rent model, however, because it allows us to "see" each expense of the Property in the DCF.

Second, Mr. Jabs kept net effective rent flat for four years because his research showed that the length of 1992 leases was three to five years. He increased the figure in the fifth year of his DCF to account for lease-renewal market increases and kept that figure flat until year nine. Mr. Boris, on the other hand, increased net rent each year to account for market increases.

We agree with Mr. Boris. A fee simple market valuation for real estate tax purposes requires the valuation of all interests in a property. TMG Life Insurance Co. v. County of Goodhue, File No. C9-94-479 (Minn. Tax Ct. Dec. 15, 1994). If we assume that market rent increased in 1993, the value of the leased fee under a flat four-year lease decreased between 1992 and 1993 and the value of the tenant interest increased. Mr. Jabs' flat income reflects only the landlord's interest in the Property.

Finally, Mr. Boris did not deduct the expense of tenant improvements from his cash flow in the final year of his DCF, arguing that the improvements add value to the Property. Mr. Jabs deducted the cost of tenant improvements in each year in his calculation of net effective rent. The DCF analysis monitors the cash flow into and out of a property; therefore the expense of tenant improvements must be deducted in each year, including the last year of the cash flow. We do not disagree with Mr. Boris that tenant improvements may enhance property value but believe that value is reflected in

increased rents.

We turn to the DFC's themselves. We do not accept the DCF value of either appraiser. Our finding of value via the DCF approach is based upon our DCF analysis run on a Lotus spreadsheet.

Income.

Mr. Jabs estimated a $0.00 market net effective rent for a Class A building and a ($1.00) net effective rent for a Class B building on January 2, 1992. His estimates are based on review of the Towle Report, his survey of May 1992 asking net rental rates for nineteen Minneapolis office buildings, actual 1992 and 1993 leases for five of those buildings and the Property's actual leases. Because he classifies the Property as 40% Class A and 60% Class B, his 1992 net effective rent for the Property is ($0.60).

Mr. Boris estimates an $8.50 market net rent for January 1992, a figure which falls within the Class A survey figures. His estimates are based on the Towle Report, an undated corporate report survey of asking net rents, one Minneapolis Class A building actual lease and actual Property leases. Mr. Boris testified that in his opinion the Property is a Class A building in a B+ location.

We agree with both experts that the Property is somewhere between a Class A and a Class B property and believe that actual rent presents the best evidence of market rent for a property. We accept Mr. Jachymowski's testimony that management did not sacrifice income to decrease vacancy and have no reason to believe that actual rent to external tenants is not market. Mr. Jachymowski testified that the existence of shadow space (space under lease and generating income but literally vacant) and the

trend toward tenant downsizing negatively influenced market rent in 1992.

We have reviewed the information regarding actual leases included in both appraisals and the testimony of Mr. Ramsland who calculated a net rent from actual leases. We conclude that actual leases reflect a January 2, 1992 net rent of approximately $5.50 per square foot. We apply that figure to 360,960 square feet of rentable space, the number used by Mr. Jabs who received his information from the owner.

As noted above, Mr. Jabs kept rent figures flat in his DCF during the term of a market lease, a concept we reject. Mr. Boris increased net rent 7% in the second and third year of his DCF, 6% in the fourth and fifth year, 5% in the sixth and seventh year and 4% thereafter. We believe the testimony regarding the oversupply of space would lead a purchaser to assume a flat rental income in year two, an increase of $0.50 per square foot in years three and four, and a 7% increase per year thereafter.[5] Both appraisers agreed that actual operating expense of $4.45 per square foot was market and increased that figure at 4% per year. We agree and include operating expense reimbursement in income. We do not include real estate tax reimbursement in income nor do we deduct it as an expense. We add a stabilized vacancy owner portion of the real estate tax rate to the terminal overall cap rate and the discount rate.

We accept Mr. Boris' 18% vacancy rate in 1992 and decrease the rate to 12% in

---

[5]. Our increase in the early years of the DCF is less than Mr. Boris' increase and in the later years of the DCF is greater than Mr. Boris' increase. Our net rent in the later years is significantly less than Mr. Jabs' predications of Class A market net rents. Petitioner's Exhibit 1 at 26a and 28.

1993, decreasing gradually to reach a 6% vacancy rate in 1996. Mr. Jabs' figures for vacancy are significantly higher, i.e., 25% in the first year decreasing to 6% in 2002, the eleventh year of his DCF. Mr. Jabs' vacancy rate figures are based upon his classification of the Property as 40% Class A and 60% Class B and upon his estimate of shadow space. We believe Mr. Jabs places too much emphasis on the Class B nature of the building in his vacancy analysis and note that actual absorption has occurred more quickly than Mr. Boris' market predictions. The effect of shadow space is better seen in the suppression of market rent, not in a decrease of net operating income due to an increased vacancy rate.

We include Mr. Jabs' miscellaneous income and arrive at an effective 1992 gross revenue (excluding real estate tax) of $2,985,073.

Expense.

We deduct $4.45 per square foot as operating expense in the first year of the DCF and increase that at 4% per year as did both appraisers. We use Mr. Jabs' $0.10 per square foot reserve figure increased at 4% per year. We use Mr. Boris' tenant improvement figures because Mr. Jabs did not include market tenant improvement data in his analysis (effective net rent deducts tenant improvement cost off the top).
Mr. Boris used the average of four years of actual tenant improvement cost in the first year of the DCF, a figure he reduced in years two and three, reasoning that the cost of tenant improvements decreases as vacancies decrease. Mr. Boris then increased the cost of tenant improvements at a rate of 5% per year.

Holding Period and Rates.

We accept Mr. Boris' ten-year holding period and the 9.5% terminal overall capitalization rate used by both appraisers. We use an 11.5% discount rate and add the owner's portion of the real estate tax rate to these rates.[6] We reach a DCF indicated value of $16,600,000 rounded.

Cost Approach.

Mr. Jabs did not perform a cost approach because: (1) he believes a buyer would not consider a cost approach to determine price; and (2) it is difficult to accurately measure economic obsolescence in an unstable market flooded with space. The relevant issue is the reliability of the cost approach, not whether a buyer would perform one. Mr. Boris performed a cost approach using fifteen land sales and an estimated replacement cost of $45,087,051. We find the cost approach useful because the building, constructed for approximately $42,000,000, was only five-years-old on the assessment date.

We have reviewed Mr. Boris' fifteen land sales and agree with counsel for Petitioner that none of the sales was an arms-length, open-market sale. Many of the land transfers were to captive purchasers suggesting a higher than market price and many were of distressed properties suggesting a lower than market price. However, we focus particularly upon the two land sales which bracket the assessment date in time and are located within two blocks of the Property at the northern end of the downtown area. Sale No. 9, a March 1992 sale, includes the purchase of an existing lease

[6]. The Property rents on a net rent basis with the tenant paying its share of expenses including real estate tax. We add .34% to the TOAR and discount rate for the owner portion of the property tax expense with a stabilized vacancy rate of 6% and a 1992 tax rate of 5.73%.

suggesting the buyer may have overpaid. Sale No. 11A, an October 1991 sale, was clearly a distressed sale. The average of Mr. Boris' adjusted value numbers for these sales sets a $38 per square foot price or $2,025,000.

Mr. Boris reduced the building replacement cost building value for physical, functional and economic depreciation. He based his physical depreciation deduction upon the five-year age of the building over a sixty-year life. We rely upon the testimony of Mr. Ramsland who indicated that the more accurate estimate of physical depreciation accounts for short-lived items and long-lived items separately.[7] Mr. Ramsland, using Mr. Boris' replacement cost figures as a base, determined that the building suffered from $6,532,000 of physical depreciation for short-lived items and $1,470,000 for long-lived items.

Mr. Boris estimated economic obsolescence of approximately 20% of replacement cost but included no supporting data for this estimate. Mr. Ramsland, using a net rent of $5.50 per square foot, determined economic obsolescence by calculating the net income loss to the Property, a method endorsed by the American Institute of Real Estate Appraisers, The Appraisal of Real Estate, 358 (10th ed. 1992). We use Mr. Ramsland's method to determine economic obsolescence but use stabilized $6.50 per square foot net rent figure because the $5.50 market rent figure used in our DCF for 1992 reflects the bottom of a temporarily distressed market. Our estimate of economic obsolescence is $12,900,000. We accept Mr. Boris' estimate of

---

[7]. See also, American Institute of Real Estate Appraisers, Appraisal of Real Estate, 351 (10th ed. 1992).

functional obsolescence and arrive at a depreciated building value of $20,500,000. We add our $2,025,000 land value and arrive at an indicated value by the cost approach of $22,525,000 rounded.

We place equal weight upon the DCF and cost approaches and arrive at a final opinion of January 2, 1992 value of $19,600,000.

K.D.