BOARD OF ASSESSMENT APPEALS, **STATE OF COLORADO** 1313 Sherman Street, Room 315 Denver, Colorado 80203 Petitioner: **HUB PROPERTIES TRUST,** v. Respondent: **ARAPAHOE COUNTY BOARD OF EQUALIZATION.**	
Attorney or Party Without Attorney for the Petitioner: Name: Alan Poe, Esq. Holland & Hart LLP Address: 8390 E. Crescent Parkway Greenwood Village, Colorado 80111 Phone Number: (303) 290-1616 E-mail: apoe@hollandhart.com Attorney Reg. No.: 7641	**Docket Numbers: 38880 and 38905**
ORDER	

THIS MATTER was heard by the Board of Assessment Appeals on February 11, 2004, Debra A. Baumbach and Steffen A. Brown presiding. Petitioner was represented by Alan Poe, Esq. Respondent was represented by George Rosenberg, Esq.

PROPERTY DESCRIPTION:

Subject property is described as follows:

800 and 860 Potomac Circle, Aurora, Colorado
(Arapahoe County Schedule Nos. 1975-06-3-08-006 and 1975-06-3-08-009)

Petitioner is protesting the 2001 actual value of the subject property, a four-story, multi-tenant medical office building. The subject property was built in two stages. The first phase, constructed in 1984, contains 59,073 square feet. The second phase contains 55,466 square feet and was constructed in 1992. The properties appear to be a single building and are considered to be a single economic unit.

ISSUES:

Petitioner:

Petitioner contends that the subject has been overvalued. Although Petitioner and Respondent's income approaches are similar, there are four main differences:

A. The area used to determine net rentable square footage versus gross square footage

B. Market rental rate

C. Vacancy rate

D. Capitalization rate

Respondent:

Respondent contends that the subject has been properly valued using the income approach. HUB Property Trust, a Real Estate Investment Trust (REIT), owns the subject property. Columbia Health Care (HCA) holds the master lease and is an AAA tenant. There are sub-leases, but the Division of Property Taxation (DPT) guidelines indicate that only the master lease is to be considered; tenant sub-leases do not affect the owner's property income. The value presented is fee simple.

FINDINGS OF FACT:

1. The Board granted a motion to consolidate Docket Numbers 38880 and 38905. For assessment purposes, the properties are identified by two separate schedule numbers since they were constructed in two separate phases, but the building is operated as one multi-tenant office building. At issue is the 2001 valuation of the subject properties: 860 Potomac Circle (Docket No. 38880) and 800 Potomac Circle (Docket No. 38905).

2. Petitioner's witness, Mr. James R. Burbach, MAI, presented the following indicators of value:

Market:	$6,160,000.00
Cost:	Reviewed Only

Income: $7,100,000.00

3. Based on the market approach, Petitioner's witness presented an indicated value of $6,159,000.00 for the subject property.

4. Mr. Burbach testified that the subject property is located west of Interstate 225 and just north of 6th Avenue. He personally inspected the subject property commonly known as 830 Potomac Circle. The west building was constructed in 1984 and contains 55,466 square feet of Gross Building Area (GBA), defined as the outside measurements; the east building was constructed in 1992 and contains 59,073 square feet of GBA for a total GBA of 114,539 square feet. Based on his inspection, the weighted age of construction was estimated to be 13 years. The building is four stories high with one central elevator core. The exterior of the first floor is plaster stucco and the upper three floors are glass panel. The subject occupies 5.34 acres of land and includes surface parking.

5. Mr. Burbach defined usable rentable area as the actual area used by the tenant, including restrooms but excluding stairs, elevators and HVAC areas. For example, Mr. Burbach referred to an area of 900 square feet. A load factor of 10% is applied which includes the halls; 900 square feet x 1.1 = 990 square feet. Using $15.00 per square foot for usable area equals an annual rent of $13,500.00. To calculate a rentable figure, a multiplier of .91 or $13.65 per square foot is used and is based on the building efficiency ratio estimated between 80% and 90%. Mr. Burbach analyzed the stacking plans shown on pages 39 through 46 and Addendum B of Petitioner's Exhibit A, and concluded that the subject property has 108,359 square feet of net rentable area and 98,518 square feet of usable area. Usable area is the actual office space used by a doctor and the lease is based on usable space.

6. Petitioner's witness presented nine comparable sales ranging in sales price from $3,800,000.00 to $14,500,000.00 and in total net rentable area from 39,957 to 156,592 square feet. Before adjustments, the sales prices ranged from $92.60 to $126.39 per square foot. Adjustments were made based on the comparison of the Net Operating Income (NOI), which ranged from $8.57 to $12.13 per square foot. The adjusted prices ranged from $47.19 to $64.88 per square foot before rent loss/absorption and deferred maintenance.

7. Referring to the sales comparison approach in Petitioner's Exhibit A, page 81, Mr. Burbach testified that eight of the sales were between 90% and 100% occupied, three of the properties had structural parking, all of the sales were good Class B buildings and all had better locations than the subject property. Because adjustments based on price per square foot would be significant due to physical and locational differences, Mr. Burbach testified that he valued the subject property using an economic unit of comparison based on the net operating income per square foot of rentable area. Although this is not standard practice, it is an acceptable method that indicated $60.00 per square foot of net rentable area or $6,500,000.00. An additional adjustment was needed to reflect a stabilized occupancy of 85%, resulting in an indicated value of $6,160,000.00. Mr. Burbach placed little weight on this approach to value.

8. Petitioner's witness did not present a cost approach. Mr. Burbach testified that prospective purchasers do not rely on this approach to value.

9. Based on the income approach, Mr. Burbach concluded to a value of $7,099,000.00 for the subject property.

10. Mr. Burbach considered the signed leases for the subject property and rental rates for other comparable properties during the base period. Due to limited availability of information on other medical buildings, generic office buildings were considered. Mr. Burbach testified that most office building rental rates are based on the square footage of net rentable area. In the case of medical office buildings, rental rates are based on usable square footage. As referenced in Petitioner's Exhibit A, page 55, Mr. Burbach divided the subject's usable square footage (98,518 sq. ft.) by the subject's net rentable square footage (108,359) to calculate a conversion factor of 91%. After applying the conversion factor to the subject property's leases, Mr. Burbach determined a full service market rent of $15.50 per square foot for the net rentable area.

11. Mr. Burbach also presented eight comparable office buildings with leases that ranged from $17.50 to $24.00 per square foot on a net rentable area basis. Mr. Burbach testified that the subject property is more representative of a high quality Class C or a low quality Class B building, whereas the rent comparables were more representative of a good quality Class B building. He applied an adjustment of 15% based on median rental rates between Class C and Class B buildings in three different sub-markets. Considering the superior location of these rentals, further consideration was given to the adjustment to conclude a market rental rate for the subject property of $15.50 per square foot on a full-service basis on the net rentable area of the building. He calculated the potential rental income of the subject property to be $1,679,565 per year.

12. Vacancy and collection loss represents both rent loss by vacancy and credit loss projected for the subject. Mr. Burbach testified that he used a stabilized vacancy rate based on a holding period of five to 10 years. As shown in Petitioner's Exhibit B, a market analysis was used from the subject property, as well as from the northeast and southeast sub-markets, to determine a vacancy and collection loss factor of 15% for the subject property. Mr. Burbach referred to Petitioner's Exhibit A, page 67, a stabilized pro forma operating statement for the subject, and testified that Other/Miscellaneous Income included late fees and vending machine income. Expenses were not only based on the subject property's historical information, but also on supplemental information from the Building Owners and Managers Association (BOMA) to derive a NOI of $600,593.00. Mr. Burbach relied on the Integra Joseph Farber & Company –Real Estate Investment Survey – Winter 1999/2000 Report contained in Petitioner's Exhibit A, pages 70 through 76, to determine a capitalization rate. He estimated a stabilized or fee simple base rate of 10% and added the tax load of 2.23% resulting in a 12.23% capitalization rate. The indicated value by the income approach of the subject property is $7,440,000.00 based on direct capitalization.

13. Mr. Burbach testified that he did not feel the indicated value of $7,440,000.00 was stabilized and that it needed to be further adjusted for deferred maintenance, estimated at $10.00 per square foot based on a tenant improvement analysis. Since the subject was only 69% occupied as of January 1, 2001 and the subject property's market value is based upon 85% stabilized occupancy, rent loss was calculated by using the rental rate of $15.50 multiplied by the additional square footage that would have to be leased the following year, resulting in a final market value of $7,100,000.00.

14. Under cross-examination, Mr. Burbach testified that HUB Property Trust is the owner

of the subject property and that HCA leases the building, is an AAA tenant and is a Real Estate Investment Trust. Mr. Burbach obtained the Gross Building Area (GBA) figure from Arapahoe County. Net rentable area is different; Respondent used 113,568 square feet as shown in the Lease Abstract contained in Respondent's Exhibit 1, Addendum A, and Petitioner used 108,119 square feet. Mr. Burbach agreed that the master lease rate was $11.53 from February 2, 1998 to January 31, 2003, even though Columbia can charge something else. He admitted that the vacancy could be 0% and HUB would still receive its full rental payment, so the subject property is really 100% occupied based on the rental dollars they receive. Mr. Burbach agreed that the master lease is a form of encumbrance.

15. Mr. Burbach testified that he took into consideration the Division of Property Taxation's (DPT) guidelines with respect to long-term lease valuation as shown in Respondent's Exhibit 1, Addendum D. He testified that a potential buyer would not just look at the master lease since it would depend upon the risk and whether or not the lease was at or above market. A new owner would look at the current lease rate of $11.53 per square foot.

16. Mr. Burbach was not 100% certain that the tax load of 2.32% was accurate for 2000, but it was accurate for 2001. As to the comparable rentals, Mr. Burbach testified that he used the net rentable square footage as a unit of comparison. Mr. Burbach agrees with Respondent that the subject is located on the dividing line between the northeast and southeast sections at 6th Avenue. He also agrees that medical office buildings are office buildings, but for the most part, medical office buildings assemble around hospitals. The expenses shown in Petitioner's Exhibit 1, page 66, were historical operating expenses from HCA. Mr. Burbach agreed that the master lease should not be capitalized since it would equal the leased fee value. The correct method would be to use a discounted cash flow analysis (DCF).

17. Petitioner is requesting a 2001 actual value of $7,100,000.00 for the subject property.

18. Respondent's witness, Mr. Steven R. Sneddon, a Certified General Appraiser with the Arapahoe County Assessor's Office, presented the following indicators of value:

Market:	$13,700,000.00
Cost:	N/A
Income/Direct Capitalization:	$11,140,000.00
Income/Leased Fee:	$13,540,000.00

19. Based on the market approach, Respondent's witness presented an indicated value of $13,700,000.00 for the subject property.

20. Respondent's witness deleted Comparable 6 from Respondent's Exhibit 1, pages 25 and 29. He presented five comparable sales ranging in sales price from $1,445,000.00 to $3,200,000.00 and in size from 26,596 to 50,564 gross square feet, or from $54.33 to $95.30 per square foot. He determined that insufficient market data existed to make quantitative adjustments; therefore, only qualitative adjustments were considered.

21. Mr. Sneddon testified that even though Comparable Sale 6 was deleted because it was

a land lease, the Respondent's final opinion of value has not changed.

22. Mr. Sneddon agreed with Petitioner that HCA, a national health care company, is the largest healthcare provider in Denver and that HUB Property Trust is a REIT specializing in medical properties.

23. Mr. Sneddon described the subject property as an average Class B office building, a modern facility with little deferred maintenance. A Class C property is an older building with functional obsolescence and would have a lower rental rate.

24. Mr. Sneddon testified that he did not use the cost approach. The market approach was inconclusive as the sales lacked comparability and he did not put much weight on this approach. An investor would rely on the income approach, particularly the leased fee interest.

25. Mr. Sneddon testified that he considered both the leased fee and fee simple interests and concluded to two values. He took into consideration the DPT guidelines concerning the unit assessment rule as set forth in Respondent's Exhibit 1, Addendum D, Volume 3, pages 7.15 through 7.19 of the Assessors Reference Library (ARL). Mr. Sneddon concluded to a fee simple value of $11,140,000.00 and a leased fee value of $13,540,000.00.

26. Mr. Sneddon testified that the subject has 113,568 square feet of rentable area according to the master lease with Columbia-HealthOne LLC. Referring to Respondent's Exhibit 1, pages 31 and 32, Mr. Sneddon discussed the four medical rental office properties. He testified that he obtained some of the data for Lease 1, Dry Creek Medical Office, from CoStar Realty Information. He believes the information may be suspect; he thinks the rental rate is a gross figure and not net. The rents shown for Lease 2, Centennial MOB II; Lease 3, Aurora MOB I; and Lease 4, Aurora MOB II were obtained from actual rent rolls. Mr. Sneddon made a correction to Aurora MOB II where rents were actually $16.15 and $14.45 per square foot rather than $19.00 and $17.00 per square foot. Mr. Sneddon did not make a distinction between usable and rentable area, as did Petitioner's witness, since he had never heard of rent based on usable area. Mr. Sneddon concluded to a fee simple rate of $18.00 per square foot.

27. As to vacancy, Mr. Sneddon testified that he focused on the southeast area since he feels the subject is influenced more by this area than the northeast area. He referred to Petitioner's Exhibit B, page 14, which shows the various sectors in metro Denver and concluded to a stabilized vacancy of 7.76%. In the category of other income, which is revenue from different methods including percentage rent, Mr. Sneddon testified that this information was not available for the subject property. As to expenses, Mr. Sneddon consulted the 2001 BOMA Experience Exchange Report, which contains actual data compiled from their members. Mr. Sneddon reviewed the city analyses for Denver suburban offices ranging in size from 100,000 to 299,999 square feet. BOMA's data on medical office expenses was available, but only on a national level. The median expense for office buildings was $5.16 per square foot per year. Based on BOMA's reported difference in operating expenses between the national medical and national office buildings, a factor of 5.7% was applied, which indicated $5.45 per square foot for medical office building expenses. The actual 1999 and 2000 expenses for the medical office building located at 730 and 750 Potomac Street ranged from $5.22 to $5.77 per square foot before property taxes. Mr. Sneddon concluded to an

expense rate of $5.50 per square foot for the subject property.

28. Mr. Sneddon considered several sources for a capitalization rate. Referring to Respondent's Exhibit 1, pages 35 through 36, he testified that he used the market extraction rate from four sales obtained from CoStar COMPS and the investor survey method from Integra Realty Resources, Joseph Farber and Co. He gave most weight to the market extraction method to conclude to an overall capitalization rate of 9% for the subject property. Mr. Sneddon referred to page 37 of Respondent's Exhibit 1, which is a line-by-line summary of his conclusions. The indicated fee simple value by direct capitalization was $11,139,293.00 for the subject property.

29. Mr. Sneddon testified that he placed the most weight on the leased fee interest as an investor would also put considerable weight on the lease and would therefore purchase the leased fee interest. Referring to Respondent's Exhibit 1, pages 37 and 38, Mr. Sneddon testified that the subject property is 100% leased on a triple-net, long-term basis. Using the $11.53 per square foot contract rent from the master lease, and allowing 5% for vacancy and collection loss, 2% for operating expenses, and an overall net capitalization rate of 9%, Mr. Sneddon concluded to a leased fee value of $13,539,600.00.

30. In cross-examination, Mr. Sneddon reiterated that even though the fee simple value is lower, a potential investor would look at the leased fee interest. Referring to Respondent's Exhibit 1, Addendum E, the witness testified that HUB also received more than fee simple since they also got the assigned leases. As to gross square footage, Mr. Sneddon testified that the master lease indicated 113,568 square feet. Mr. Sneddon testified that the main differences between the two appraisal reports are the vacancy rate, square footage and the rent per square foot; however, the indicated expenses are similar. As to the capitalization rate, he chose a lower rate since it was a medical building. When asked about the deduction for the leased fee interest, Mr. Sneddon referred to Respondent's Exhibit 1, Addendum D, page 7.15 from the ARL citing long-term lease valuation.

31. In redirect, Mr. Sneddon testified that medical office buildings and commercial office buildings are similar and that one would consider the subject's sale outside the base period. Mr. Sneddon testified that he would consider a lease of less than ten years with a single tenant but would place more weight on a long-term lease. The subject has an above-market lease. The leased fee interest is what is being sold. As to Petitioner's Exhibit A, page 81, the column entitled Net Operating Income Per Square Foot is an after expense figure and is similar to the subject's master lease number.

32. In re-cross examination, Mr. Sneddon testified that the subject's prior sale was based on leased fee interest; the tenants were not sold.

33. In rebuttal, Mr. James Burbach testified that he or someone from his office confirmed the NOI on the comparable sales. The total rentable area shown in Petitioner's Exhibit A, Addendum B, was usable square footage. He placed most weight on the market rates shown for the subject property in Petitioner's Exhibit A, page 55. Comparable rentals had better finish and a qualitative adjustment was needed. Respondent's rentals, MOB I and II, are connected with a hospital, which is more advantageous. In addition, if the area were converted to rentable square footage, it would support his value of $15.50 per square foot. Mr. Burbach testified that Respondent

used a point-in-time vacancy rate, which is incorrect. A loaded capitalization rate is appropriate for ad valorem purposes and must be added back. Mr. Burbach reviewed Respondent's sales and testified that three of the four were Class A buildings, were 100% occupied and indicate a capitalization rate of 9.3% to 9.6%; however, he believes that the subject's capitalization rate should be higher.

34. Mr. Burbach testified that the Stabilized Pro Forma Operating Statements shown on pages 67 and 68 of Petitioner's Exhibit A do not reflect actual income and expenses.

35. Mr. Burbach testified that he would not consider the master lease good in and of itself; the tenants must also be considered.

36. Respondent assigned an actual value of $13,900,000.00 to the subject property for tax year 2001. Respondent is recommending a reduction in value to $13,540,000.00.

CONCLUSIONS:

1. Petitioner presented sufficient probative evidence and testimony to prove that the valuation of the subject property for tax year 2001 was incorrect.

2. The Board agrees that the income approach is the most appropriate method to value the subject property, and that the area, rental rate, vacancy rate and capitalization rate are the main issues.

3. The total building area is 114,539 square feet. At issue is the difference between rentable versus usable square feet. The Board agrees with Petitioner that usable square footage is valid and that the application of a conversion factor is appropriate.

4. The Board notes that the Aurora MOB I and MOB II properties used by Respondent are in close proximity to the subject, and are similar in age. The lease rates of Aurora MOB I and MOB II range from $14.45 and $16.15 per square foot, similar to the signed leases for the subject property. Even though they are older leases the Board believes they are more comparable to the subject property than those located in the southeast quadrant. The Board believes that a rental rate of $15.50 per square foot is reasonable for the subject property.

5. Considering the subject property's vacancy rate during the base period, the Board is most persuaded by Petitioner's stabilized vacancy rate of 15%. Petitioner's stabilized vacancy rate was calculated over a period of time.

6. The Board finds a 10% capitalization rate to be appropriate.

7. The Board re-calculated the value of the subject property using $15.50 per square foot multiplied by 108,359 square feet, to conclude to a rental income of $1,679,565.00. Using a 15% vacancy and collection loss and expenses at $5.50 per square foot, and adding miscellaneous income results in an NOI of $831,655.00. Adding the real estate taxes of $309,537.00 yields $1,141,192.00 to be capitalized with the tax adjusted/loaded capitalization rate of 12.23% equals $9,331,087.00. The Board agrees with Petitioner that deferred maintenance and a rent loss/absorption should be considered and deducted, giving an indication by direct capitalization of $8,990,087.00.

8. The Board agrees with Respondent that since the subject is encumbered by a long-term lease, the lease fee interest must be considered. The master lease is $11.53 per square foot and there are 12 years remaining on the lease. In *City and County of Denver, et al, v. BAA and Regis Jesuit Holding, Inc., 848 P.2d 355 (Colo. 1993)* the Supreme Court stated, "We do not hold that actual rent is the only factor to be considered in valuing property, nor is it necessarily the predominant factor, only that theoretic market rent is not the exclusive factor to be considered." C.R.S. 39-1-106 establishes the need for a "unit assessment rule." The Board believes that neither Petitioner nor Respondent applied the correct formula in valuing the subject property. In the case of the subject where there are sub-leases, the original lessee is sandwiched between the lessor and the sublessee. The original lessee's interest has value if the contract rent is less than the rent collected from the sub-lessees or the market rent. The leased fee interest holds less risk because the rent is fixed and not subject to market volatility. The Board believes the discount rate of 9.5% is appropriate.

9. Following the example from the Assessors Reference Library (ARL) with regard to Unit Value For Assessment, the Board calculated the annual rental difference to be $430,185.00 ($15.50 - $11.53 x 108,359 square feet). The next step is to amortize the annual rent difference using the present worth of $1.00 per period given 12 years remaining on the master lease, or a factor of 6.983830 (9.5%) or $3,004,339.00 which is added to the fee of $8,990,087.00 for a true value of $11,994,426.00.

10. Based on all of the evidence and testimony presented, the Board concluded that the 2001 actual value of the subject property should be reduced to $11,994,426.00.

<u>ORDER:</u>

Respondent is ordered to reduce the 2001 actual value of the subject property to $11,994,426.00.

The Arapahoe County Assessor is directed to change his records accordingly.

APPEAL:

Petitioner may petition the Court of Appeals for judicial review within 45 days from the date of this decision.

If Respondent alleges procedural errors or errors of law by this Board, Respondent may petition the Court of Appeals for judicial review within 30 days from the date of this decision.

DATED and MAILED this 22nd day of April, 2004.

BOARD OF ASSESSMENT APPEALS

Debra A. Baumbach

Debra A. Baumbach

Steffen A. Brown

This decision was put on the record

APR 2 2 2004

I hereby certify that this is a true and correct copy of the decision of the Board of Assessment Appeals.

Penny S. Lowenthal

Penny S. Lowenthal

STATE OF COLORADO
SEAL
BOARD OF ASSESSMENT APPEALS

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