VALUATION VIEWPOINT

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Damages During Road Construction Projects

by Keeshawn Aleksuk and Robert Strachota

In the real estate world, the government has the legal power to take all or a portion of private property if the property is necessary for public use. Just compensation is the payment the government has to pay for taking private property. This process is referred to as eminent domain – the government's power of condemnation. Just compensation in eminent domain is measured as the "fair market value" of the property, or the hypothetical price the real estate would bring after fair and reasonable negotiations between willing buyers and sellers as of the date the property is taken. In the appraisal industry of real estate, appraisers find the difference of the property's value before the taking (before value) less what it is worth after the taking (after value), with the difference being the just compensation due to the property owner. Additionally, it should be noted that there are at least three categories of damages that need to be addressed to correctly provide just compensation during eminent domain: the direct taking of real property, construction damages, and permanent severance damages.

- Direct taking refers to the "fair market value" of the private property that is being taken during condemnation.
- Construction damages refer to the damages to the property from construction-related interference that occur on and after the date of taking. (All of the property, not just the portion being taken.)
- Permanent severance damages refer to the amount of damage to the remainder of the property when a portion has been taken during condemnation. (Result from Construction damages + Permanent diminution of value to the remaining property)

An appropriate condemnation action will address all three categories of damages. However, the government oftentimes neglects the construction damages category since these damages can occur for several years after the actual date of taking and, in the government's opinion, are often considered non-compensable. Therefore, it is the appraiser's ethical responsibility to find how the market reacts to all the government's activity in an eminent domain action.

Historically, construction interferences would most often occur no more than one year, making it difficult in the marketplace to measure these damages. When analyzing a property with a construction period of a year or less, it is challenging for the appraiser to track how the road construction project is damaging the whole property since there is a limited amount of market evidence regarding short-term impacts to many different types of properties.

However, when damages during construction are greater than one year (let's say a period of three, four, or even five years), the appraiser can track the performance trends of the marketplace and property at hand, clearly recognizing the diminution of value to the property.

National Market Trends & Value Indicators

High Qual. Institut'l Grade	Value ∆ Over Past 12 Mo.
Office	-1%
Mall	12%
Strip Retail	15%
Industrial	18%
Apartment	7%
Health Care	4%
Lodging	8%
Manufactured Home Park	6%
Self-Storage	28%

	YoY Change
New Housing Starts - Q2 Midwest*	12.58%
Productivity**	-2.5%
U.S. Unemployment***	35.19%
Consumer Confidence Index****	-25.87%

Real Estate Indicators from Green Street Advisors CPPI Report, *Source: St. Louis FRED, ** 2Q 2021/2Q 2022 – Source: Bureau of LaborStatistics, *** Jul 2021/Jul 2022 – Source: Bureau of Labor Statistics, **** Jul 2021/Jul 2022 – Source: The Conference Board

Supply Chain Crisis

by Thomas Bauer

Amid the recovery from the Covid-19 pandemic, the global economy was hit with yet another major setback: a supply chain crisis. Global supply chains have been under extreme pressure recently, with several major transportation and logistics companies reporting backlogs at ports of entry and lost cargo. These delays have been caused by several factors: worker shortages, surging demand, low safety stocks, and high commodity volatility.

The United States is currently experiencing the worst worker shortage in decades. The recent jobs report from the Bureau of Labor Statistics stated that the economy added 315,000 jobs in August. Wages continue to rise, albeit at a slower pace than overall inflation. The job market is still very strong and demand for workers outpaces supply. At the end of June, there were still nearly twice as many jobs openings as unemployed workers. This worker shortage has hit the transportation industry particularly hard, resulting in an estimated 80,000 unfilled semi-truck driver positions in 2021. This shortage has made it difficult for shipping companies to bring goods to and from ports to stores, resulting in further congestions at ports and ultimately, goods left to sit on container ships.

"These supply chain issues have affected nearly every industry."

As the economy emerged from the Covid-19 pandemic, consumers found themselves with higher disposable incomes than they had seen since 2019. This was driven by more people returning to work, as well as stimulus checks, leaving people with extra cash. Further, with inflation being high, 8.5% annually as of the end of July, consumers have little incentive to save this money, as its purchasing power dwindles, with long term interest rates well below inflation. This has caused demand for many goods to rise beyond what analysts had forecasted, resulting in shortages of goods. This supply chain crisis has been particularly hard felt by consumers, due to the popularity of lean and just-in-time (JIT) operation strategies. In an effort to cut costs in an increasingly competitive global economy, many companies have adopted operational and manufacturing strategies that involve holding minimal inventory, allowing for a more efficient use of capital. However, this has resulted in a decrease in the safety stock held in warehouses across the country. When shipments from ports became delayed, companies had no extra inventory they could draw on to sell to consumers. As such, shelves in stores across the country are left unstocked.

The war in Ukraine has also had an adverse effect on the health of global supply chains through rising prices of commodity items. When Russia invaded Ukraine in March 2022, western power placed harsh sanctions aimed to punish Russia for its military actions. These sanctions prevented the importation of many key goods from Russia. Russia and Ukraine are major producers and exporters of wheat, corn, and oil. The disruptions of global commodities have led to sharp increases in both future and spot prices, which has in turn increased the price of consumer goods derived from these commodities, like food and gasoline.

These supply chain issues have affected nearly every industry, but certain industries have been hit harder than others. For example, the automotive manufacturing industry, an industry known for its use of lean and JIT manufacturing, has seen rising prices and shortages of important components. Automotive manufacturers were forced to cut unit production in 2020 and 2021 after sourcing departments were unable to acquire semi-conductor chips for their vehicles. Semi-conductor chips, also known as microchips, are used in almost every electronically controlled system in modern vehicles, like cruise control, airbags, and lights. As a result, there is a massive shortage of new and used vehicles on the market. This has caused the average used car price to increase 36.9% between January 2021 and January 2022.

Supply Chain Crisis
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Another good that has been uniquely affected by these issues is baby formula. Demand for the product outpaced analysts' expectations, leaving grocery store shelves bare and parents unsure where they can find this essential product. Manufacturers have struggled to increase production, as their efforts have been met with difficulty in obtaining ingredients and packaging materials, as well as securing transportation to warehouses and store shelves.

In the short-term, companies may see lower revenues and higher transportations costs as they struggle to source their raw materials and get finished products to shelves. In the long-term, companies may move away from lean and JIT operations by maintaining higher levels of inventory to avoid future supply chain issues. An industry-wide increase in inventory would increase the level of working capital companies maintain. Since working capital typically provides a lower return to shareholders than alternative uses of capital, we may see lower overall returns for companies. While a lower level of returns could lower company valuations, the lower level of risk associated with profits may offset this impact. The result may be companies that have less risky, less efficient operations as a way to mitigate supply chain risk.

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The evidence can be seen in the cost approach (more depreciation, functional or economic obsolescence), income approach (a decrease, slight, or even no cash flow coming from the property when examining the DCF), and the sales approach (adjustments made for the conditions of sale or expenditures made immediately after purchase – for example, to bring the property back to its "before" state).

There has been evidence of these damages being upheld in Minnesota law in two cases: 1992 Minnesota Supreme Court Decision State v. Strom, 493 N.W. 2d 554 (Minn. 1992) and County of Hennepin v. Laechelt, A19-0473 (Minn. 2020).

1992 Minnesota Supreme Court Decision State v. Strom, 493 N.W. 2d 554 (Minn. 1992): Evidence regarding often changing and difficult access routes was a form of construction interference evidence that could be considered by the fact finder in the case. Additionally, the Court held that evidence of noise, dust, and vibrations generated by the project could also be considered by the fact finder.

Evidence: During construction the occupancy of the office building (subject) at issue dropped from 91.6% to 56.7%, and the net rental rate dropped from $10.59 per square foot to $7.90 per square foot. Evidence of these temporary losses in the ability of the property to generate revenue is admissible in a condemnation case.

County of Hennepin v. Laechelt, A19-0473 (Minn. 2020): Evidence of construction-related interference that comes into existence after the date of taking – "simply provides the benefit of hindsight." Such evidence "may shed light on what a willing buyer and seller might reasonably expect" as of the date of taking.

Evidence: Property owner's submitted photographs and testimony of how the construction project impacted her property.

In conclusion, an experienced appraiser strives to mirror the full behavior of the marketplace. It is the appraiser's responsibility to show all consequences of an eminent domain action. It is the courts responsibility to decide what is legally compensable. Thus, the appraiser should discuss and display all damages so the court can clearly understand how buyers and sellers handle the consequences of a road construction project.

MARKET TRANSACTION
Real Estate

Hines Purchases Parking Lot

In December 2020, Hines, a privately owned real estate investment, development, and management firm out of Houston, Texas, purchased a surfaced parking lot in downtown Minneapolis for $8.4 million. It is .82 acres of land on the 900 block of Marquette Avenue next to the popular Prince music mural on the Schmidt Music Building.

Hines has announced plans to build a 29-story office tower with 719,000 square feet of office space, 21,000 square feet of retail/restaurant space and 183 underground parking stalls. Construction is expected to start sometime in 2023, with a plan to open in 2026. However, Hines has stated that they will require a commitment of approximately 175,000 square feet of space, one quarter of the available office space, before they begin construction. Many view Hines' investment decision as a long-term endorsement of the Minneapolis downtown real estate market.

Buyer: Hines, Houston, Texas

Seller: Steve Greenberg, Scottsdale, Arizona

Property: 900 Block Marquette Avenue, Minneapolis

PID: 12-345-67-89-0000

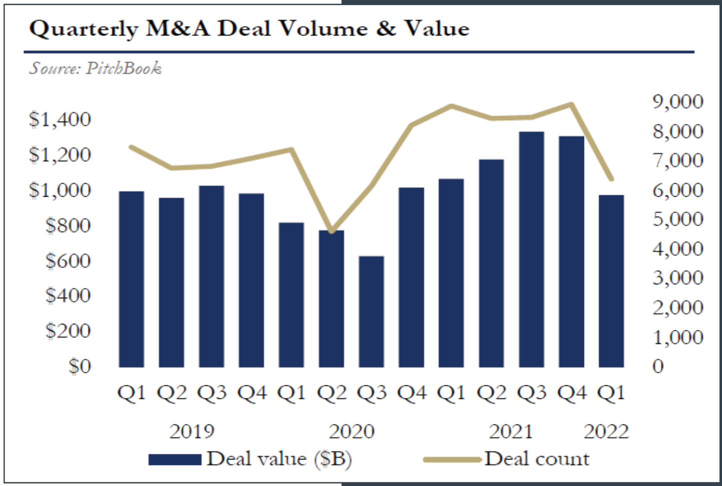
Sale Price: $8.4 Million

MARKET TRANSACTION
Business

by Dave Santoni, Managing Director, Hennepin Partners

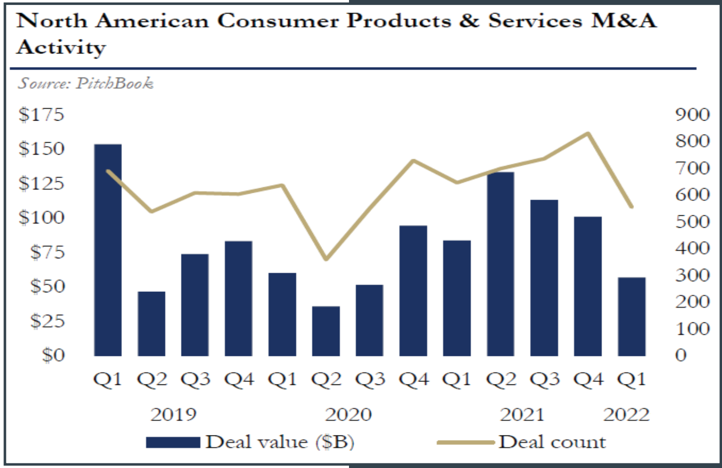
Russia's Invasion of Ukraine Disrupts M&A Activity

North American M&A activity experienced a slight dip in value and volume in Q1 2022 created by Russia's invasion of Ukraine. Approximately 4,739 deals closed for a combined value of $611.3 billion, which marks a 20% decrease in both value and volume from Q4 2021. Nonetheless, M&A activity remained in line with that of the last five years, demonstrating market resilience despite volatility and continued challenges to the international supply chain. Heading into Q2, we are seeing an increased proportion of smaller transactions, proving out the resiliency in the lower middle market. Larger deals, however, have been put on pause as investors grapple with the fallout from geopolitical conflict – this will likely persist throughout the coming quarters. Western sanctions and public disapproval has pushed investors to divest their Russian holdings, including many major US-based companies that have cut ties with the country and abandoned their Russian assets. Even if more violence is avoided, Russia's invasion has had numerous effects on the global supply chain, including oil & gas, food, electronics and others.



Sector Spotlight: Consumer Products & Services

North American dealmakers executed 1,221 transactions valued at $128.3 billion in Q1 2022, marking YOY decreases of 28% in deal count and 33% in deal value. Despite strong vaccination rates and loosening Covid-19 restrictions across the globe, accelerating inflation has significantly dampened household spending power and, consequently, squeezed spend on consumer products. This has put downward pressure on consumer M&A, as ever-changing consumer behavior functions as a primary catalyst for M&A activity. Despite decreased growth across the consumer products & services industry, the automotive professional appearance industry, which has seen tremendous growth over the past five years, emerges as a particular area of interest and is expected to experience robust growth going forward. As automotive care spending increases, the global professional appearance products market is poised to grow at a 5.9% CAGR through 2027.



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