FEATURES

Net Liquidation Valuation of Transportation Corridors

by *Arthur G. Rahn*

ABSTRACT

This article stresses the need for intensive investigation when considering the potential highest and best use of portions of transportation corridors being converted to alternative uses.

Previous articles have considered the concept of the enhancement factor[1] and the across the fence (ATF) methodology[2] as they apply to the valuation of transportation corridors. However, these concepts only apply when the highest and best use is for a continued corridor operation, be it pipeline, rail operations, fiber optic, or freeway.

The author proposes to examine the valuation problem when the highest and best use is no longer for any type of corridor operation. This can occur due to changes in technology, community growth patterns, or market demographics. For example, an examination of the Los Angeles area on older Southern Pacific railroad maps, called *valuation sections*, shows stations such as Studebaker, Firestone, and General Motors. Yet, when visiting these sites, one finds shopping centers, office buildings, and housing developments. This has been a common occurrence all around the United States; once burgeoning industries have either died out or moved on to better locations, eliminating the need for the transportation corridor, which was once their lifeline to the marketplace.

Overview

As in all appraisals, the fundamental principle in planning a corridor appraisal is that of highest and best use. If, in the appraiser's opinion, the highest and best use of the site is for continued corridor operation, then ATF methodology is the correct approach to be used. If, however, there is no demand for any continued corridor use, then the subject should be viewed as being divided up into smaller parcels for the best noncorridor use, consistent with surrounding land subdivision,

1. Arthur G. Rahn, "The Enhancement Factor in Transportation Corridor Sales and Appraisals," *The Appraisal Journal* (January 1999): 89–92.
2. Arthur G. Rahn, "Across the Fence Methodology for Valuation of Corridors: What Is It and How Is It Used?" *The Appraisal Journal* (July 2001): 270–276.

and sold to the adjacent owners or other interested parties. Note that the previous sentence says, "any continued corridor use." Just because the railroad may have removed its rails and ties does not mean the land no longer has a corridor use. There may be pipelines, gas lines, water and sewer systems, and fiber optic lines still present, which means there is still a continuing corridor use despite the absence of the railroad. There may be proposals for future uses such as street extensions, cable television, or other utilities. It is not enough to look at a corridor, see that the rail improvements have been removed, and conclude that the highest and best use is no longer as a corridor.

In the railroad industry, this process of dividing up a former corridor into smaller parcels and selling them off is called *liquidation*. When the valuation process includes allowances for marketing time and expenses, the result is called *net liquidation value* (NLV).

Definition of Liquidation

The term *liquidation* has been defined in a variety of ways. One dictionary says that it means, "to convert (inventory, securities and other assets) into cash."[3] Another dictionary defines liquidation price as, "A price paid for a property sold to liquidate a debt. Usually less than market value since there is pressure to sell or a forced sale, either of which does not usually bring the highest price."[4] Still, a third dictionary describes liquidation as:

1. Forced or voluntary cash realization. The selling of real estate, stocks, bonds or other investments, either to take profits and limit losses or in anticipation of declining prices.
2. The termination or conclusion of a business or real estate operation by converting its assets into cash.[5]

All these fall short in defining liquidation as it applies to transportation corridors. Obtaining cash is seldom the reason that a corridor is dismantled. More likely, it is done to escape maintenance costs or insurance liabilities along with other burdens of management such as taxes or weed control. Time or pressure to sell is not usually a factor since the railroad company has probably owned the corridor for over one hundred years and could keep it for another one hundred years without suffering any serious handicap. Finally, the idea that the value received is something less than market value is not correct since what the appraiser is searching for is the market value under an alternative highest and best use. In 1976, the Interstate Commerce Commission (ICC) defined *net liquidation value* in Section 1121.43(c) of CFR 1121, Title 49, which says, in part:

> This value shall be determined by computing the current appraised market value of such properties for other than rail transportation purposes, less all costs of dismantling and disposition of improvements necessary to make the remaining properties available for their highest and best use and complying with applicable zoning, land use and environmental regulations.

In 1978, this definition was again used but the section number was reclassified as part of 49 CFR 1121.44(c). In the author's opinion, this definition is the most applicable to the liquidation valuation of transportation corridors and is the one commonly used by appraisers today.

Valuation Application

As a starting point, this article is not designed to be a primer on the formal procedure called abandonment wherein a railroad makes application to the Surface Transportation Board (STB) to stop rail service between several geographic points. Information for that procedure can be obtained easily from the STB Web site, www.stb.dot.gov. Rather, this article deals with a situation where an appraiser is called upon to value a property that was once a transportation corridor but now has an alternate highest and best use.

Traditionally, an NLV appraisal of a corridor follows one of two methods. In one method, the appraiser estimates the ATF value of the individual zones or districts of the intact corridor, with no enhancement factor, and then makes market-derived adjustments for shape, size, access, or natural topography, factors that were not considered when preparing the ATF value estimate and allowing for marketing time and expense. In the second method of an NLV appraisal of a corridor, the appraiser applies a preconceived ratio to the ATF value to arrive at net liquidation value. Both methods use an ATF value as a starting point.

3. Random House, *Random House Webster's Unabridged Dictionary,* 2nd ed. (New York: Random House, 2006).
4. Henry L. Black, *Black's Law Dictionary*, 6th ed. (St. Paul: West Publishing, 1990), 931.
5. Appraisal Institute, *The Dictionary of Real Estate*, 12th ed. (Chicago: Appraisal Institute, 2001), 167.

In a recent discussion with Charles F. Seymour, MAI, a point was raised which is germane to this discussion. Mr. Seymour asked, "Where is it written that we must go through ATF to arrive at a net liquidation value? If there is adequate sales data to compare with the smaller usable parcels created from the corridor, isn't this a typical sales-comparison process in which each sales comparable is compared to the subject?" This is the right approach but it would require more analysis of the corridor parcels than has been done in the past.

In the conclusion of his October 1991 article,[6] Clifford A. Zoll, MAI, prepared a summary table that showed some acquisition factors that might generally apply to various types of rail transactions. Under liquidation sales, Mr. Zoll indicated that generally a liquidation sale might return 25%–50% of the full fee value. Unfortunately, some appraisers have taken the figures shown in the table and used them indiscriminately. Occasionally, appraisers may select a factor, such as 30%–35%, apply it to the ATF value, and call it net liquidation value. This method does not do justice to the idea of market value. In fact, an article in the January 2001 issue of *The Appraisal Journal* states:

> Evidence suggests no uniform relationship of liquidation price to market value. An appraiser cannot conclude that, because a given liquidation sale went at a discount of 23% of the estimated market value of the property, all properties will liquidate at this same 77% rate. Except for the rare cases of very similar properties liquidated at about the same time and market conditions, evidence for a market value/liquidation price ratio for the subject property is usually scarce.[7]

This procedure of discounting the ATF value to arrive at NLV was started by the railroads themselves. When the railroad no longer needed a particular corridor, they simply discounted the value by some percentage and sold the land without any regard to the market potential of the alternative uses. This attitude prevailed for a number of years until the companies began hiring real estate professionals instead of railroad officials to make marketing decisions. Even then, it was a slow and arduous process to educate the railroad people to appreciate the value of their land holdings. These transactions are the ones uncovered by Mr. Zoll and published in his article. Other appraisers have picked up the discounts shown in the article and are still using them today.

It is the author's opinion that the net liquidation appraisal should be more detailed and have considerable more analysis than is required for an ATF appraisal.

Case Studies

As an example of the depth of analysis required to complete a net liquidation valuation, let us look at a 1995 net liquidation appraisal that was performed on a northern California corridor connecting two coastal cities.

One of the segments had 4100 linear feet, varied in width from 31 feet to 100 feet and was zoned industrial. This segment of the corridor had industrial parcels on both sides and ran along their respective rear property lines. The appraiser concluded that the ATF value of the segment was $8.00 per square foot but discounted the property 50% for being landlocked, resulting in a reported liquidation value of $1,247,558.

What the appraiser did not consider was that a portion of this section of the corridor was bisected by four streets, creating eight usable lots, 100 feet wide and about 300 feet deep, one on either side of the street crossings. Lots of this size would be consistent with other light industrial properties in this area and, considered under this scenario, would have changed the liquidation estimate to $2,188,352–a gain of approximately $941,000 for this segment alone. A more accurate procedure would have been valuing the usable parcels in a typical sales comparison approach scenario and then heavily discounting those parcels that were truly landlocked.

A second segment, 2400 linear feet long, on the same corridor, had an ATF value of $12.00 per square foot, which was discounted 25% because some of the resulting lots would have been oddly shaped, and discounted an additional 10% for drainage problems. However, closer research showed that there was a number of oddly shaped lots in the immediate area, which showed no market differential in their sale prices. Thus, the liquidation value should have been $1,670,090 instead of the $1,206,176 shown in the report.

In still another example, an appraiser was completing an NLV appraisal on a seven-mile stretch of

6. Clifford A. Zoll, "Rail Corridor Markets and Sale Factors," *The Appraisal Journal* (October 1991): 504–512.
7. Max J. Derbes, Jr., and Max J. Derbes, III, "Liquidation Price and Semi-Forced Sellers," *The Appraisal Journal* (January 2001): 35.

corridor that ran through the middle of some large agricultural operations. Since the land of the corridor was considered inferior to the prime agriculture land across the fence, the ATF value was discounted heavily. However, there were two mitigating factors that were not considered. First, the farmers were using the corridor to transport heavy equipment from one field to another. Otherwise, they had to make a long drive out to the highway, move the equipment along a busy road, and then make another long drive back into the field. Second, they did not have to commit a portion of their arable land to roads and could instead use the arable land for crop production.

These are only a few examples of many that have led to the conclusion that the net liquidation appraisal requires and deserves better attention to detail than simply discounting the ATF value by some preconceived ratio.

There is a prevailing presumption, not backed up by market data, that the liquidation value is always less than the fee value. In fact, there have been recent liquidations of corridors in several areas where the sale proceeds exceeded the liquidated value computed by the conventional percentage of ATF method and, in some cases, even exceeded the ATF value.

For example, in July 1995 Southern Pacific decided to sell portions of the former Visalia Electric Railroad between Exeter and Sequoia and between Woodlake Junction and East Redbanks. This line is located in Tulare County, California, and was abandoned in 1993. The disposable property consisted of 245.882 acres, 90% of which was held in fee, and runs mostly through orchards and pastures with a few acres within small towns. The total length was 18.037 miles and the ATF value was $516,357. The sales program began in December 1995 and by the end of June 1996, 177.765 acres had been sold with gross proceeds of $811,990. At this point, the sales program was transferred to another agency. It should be obvious that even accounting for the two-year holding period between abandonment and the first sale, allowing for brokerage commissions, taxes, escrow expenses, and discounting the cash flow, that the net proceeds from the liquidation will probably exceed the original ATF value.

In Glendale, California, the abandoned West Glendale Spur track, a multitrack network in an industrial park, was appraised in March 1996 for $2,576,000 ATF and was sold in May 1997 for a net liquidation value of $2,396,990, 93% of the ATF value. This network was located in an industrial area and sold to adjacent owners.

In August 1997, the Yorba Linda portion of the abandoned La Habra Branch was appraised for $3,660,000 ATF and $1,537,000 net liquidation by the railroad and $4,200,000 ATF by an outside appraiser hired by the prospective purchaser. The net liquidation value was low because, in the railroad's opinion, there was only one feasible purchaser for the total property, the highway department, who wanted the property for the widening of Yorba Linda Boulevard. In March 1998, the land sold for $4,210,000, $1,500,000 in cash and $2,710,000 as a donation value for an IRS write-off.

Granted, all the cases presented are in California, but the principles involved are applicable to any location; there is no special application of a particular state's laws or legal precedents. The value for an abandoned corridor should be based on market data, not some preconceived formula extracted from a magazine.

One might question the feasibility of using an abandoned corridor for other than corridor purposes. After all, what use is a long skinny parcel to a typical developer? Actually, the possible uses are limited only by the imagination. In a newly published book, *Corridor Valuation*,[8] there are photographs of self-storage mini-warehouses, small commercial developments, condominiums, parks, parking lots, streets, and single-family planned unit developments all located on former corridors.

In Los Angeles, the Covina Line of the Pacific Electric Railroad, an electric railroad that served the Los Angeles basin for many years, is a perfect example of the use that can be made of odd-shaped parcels. After World War II, the increasing popularity of the automobile and the construction of regional freeways hastened the demise of the Los Angeles railroad system, where corridors were abandoned, split up into smaller parcels, and sold. Today, a tour of West Ramona Boulevard in the Baldwin Park/West Covina area will show apartments, condominiums, retail, and wholesale establishments along the north side of the street. This is the former corridor of Pacific Electric Railway that once connected Covina to downtown Los Angeles.

8. Arthur G. Rahn, *Corridor Valuation* (Fairfield, California: Arthur G. Rahn, 2005), 42–49.

An examination of current assessor maps in San Francisco, California, shows traces of the original rail corridor that was replaced about ninety years ago. Currently, there are townhouses, stores, commercial and retail buildings, apartments, parking lots, and parks where trains once ran.

Rails to Trails

There is an interesting development that offers an alternative to traditional corridor abandonment. Over time, as more and more of these corridors were abandoned, there began to be a gradual awareness that, due to the increasing traffic problems and the ever-growing need to transport people and supplies through congested areas, the existing corridors may be too valuable to be sold off in a piecemeal fashion. On the one hand, many railroads are operating, like all businesses, with limited economic resources and cannot or will not allocate the funds necessary to maintain those corridors that produce little or no income. On the other hand, government agencies want to keep the corridors intact but lack the funds necessary to acquire them.

A solution which could satisfy the needs of both parties came to pass under the *National Trails System Act*,[9] 16 U.S.C. 1247(d), commonly called "Rails to Trails." This legislation encourages states to establish trails as an interim use of railroad corridors that would otherwise be abandoned and eventually disassembled. By allowing the state to land bank corridors against the possibility of future rail use, existing corridors remain intact, rather than requiring the railroad to dispose of parcels of the corridor in a piecemeal fashion or reverting to adjacent landowners in instances where property title may be disputed. The Rails to Trails program is not an appraisal procedure, it is a program to maintain corridor integrity for future transportation needs.

This program provides for *rail banking*, a voluntary agreement between a railroad company and an agency, public or private, that supports the recreational use of an out-of-service corridor until such time as the corridor may be needed again for rail service. Since the corridor is not considered formally abandoned, it can be sold, leased, or donated to a trail manager without the portions that may have been acquired through lease, easement, or condemnation reverting to adjacent landowners. As a result, the integrity of the corridor is maintained.

Rail banking, as opposed to abandonment, may be requested by either a public agency or a private organization. The process requires the organization, called the *interim trail sponsor*, to develop the interim trail use and to assume financial responsibility for the property. Under the program, tracks and rail ties may be removed. However bridges and trestles remain in place. Any railroad can apply to STB to resume service on the corridor; however, the trail owners may be entitled to receive some compensation for the corridor if it was provided for in the original agreement between the railroad and the interim trail sponsor.

Some property owners whose lands abut the corridors argue that they should have the option to purchase the land that the railroad no longer plans to use for rail service. In a typical abandonment action, issues regarding the condition of title to the land can arise. Some parcels are sold to the railroad without any reservation to the land use. This is fee title and is fairly common with the railroad systems in the West. Other titles assign ownership to the railroad only as long as the land has not been abandoned by the railroad. In other cases, land may have been acquired by condemnation as an easement for railroad purposes only, which could raise legal questions of ownership if the corridor was abandoned.

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9. *National Trails System Act, U.S. Code* 16 (1968), §§ 1241 et seq.

Conclusion

The purpose of this discussion is to show that an appraiser cannot extract a percentage factor from a journal article and use it for every net liquidation valuation. This is an approach that deserves careful analysis of the corridor and all the uses for which it is capable of being converted. An effective and valuable net liquidation appraisal requires the following:

1. A thorough and comprehensive analysis of the highest and best use should be completed; if the property still has a corridor use due to current occupants or planned future projects, then an ATF appraisal should be planned.
2. If the highest and best use is for an alternative use, then a determination must be made of all the uses for which the property is capable of being converted.
3. An appraisal being made under an alternative highest and best use must make allowances for expenses of removal of existing improvements, if applicable, marketing and selling expenses, along with an allowance for the marketing time involved. This is admittedly a thin market and the numbers of transactions involved are few compared to the overall market. However, sales of these types of properties can involve significant amounts of money that underlie the need for proper and thorough analysis of the subject property. At the same time, the appraiser has an opportunity for a challenging and unique experience to test his or her judgment and vision.