Valuing Companies With Real Estate: Appraisal Experts Untangle the Issues
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A BVR SPECIAL REPORT
Special thanks to Rob Schlegel, FASA, MCBA, for his expert guidance and contributions to this special report.
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Introduction

The interaction of real property value and business value for “going-concern” properties is a hot topic in the appraisal profession right now. These types of businesses range from gas stations, fast-food restaurants, and hotels to marinas, campgrounds, assisted living facilities, and funeral homes. Historically, the valuation of location-dependent, special-use businesses (sometimes called “land-based businesses”) has been the domain of real property appraisers. In fact, the article “Business Appraiser or Real Property Appraiser: Which to Use?” in the appendix was released nearly 25 years ago by the American Society of Appraisers to highlight some of the alternatives and clear up confusion.

Unfortunately, confusion still reigns. There have been attempts to explain how certain types of properties could be appraised by a real estate professional, but vague terminology and suspect methodologies have drawn a good deal of criticism. This compendium of excellent articles from both perspectives should help our profession steer toward a more sensible consensus.

Valuing a business that includes real estate as a basis for competition too often offers a dilemma for the business valuation (BV) or the real property (RP) appraiser. What intangible assets should be reflected as fundamentally tied to the locational real estate? Can we independently separate those from the real property? Can we value the business as if the real property is a nonoperating asset, e.g., and add it back to the multiple of future cash flows or EBITDAR (EBITDA before rent expense)? Conversely, if the real estate is an operating asset, should we be computing value based on an earnings level of equity or invested capital because of potentially different rates of return appropriate for real estate and other, more risky, assets? While most of these assignments are typically focused in smaller, “main-street” types of businesses, what special efforts are necessary when we tangle with a large holding company of operating restaurants, hotels, or funeral homes?

The articles by Franz Ross and Alina Niculita encapsulate issues of property types and typical problems straddling the two disciplines. Franz and Alina take us through a discussion of market rent on cash flows and how BV and RP appraisers think differently. Of special interest are sections on typical business-with-real-estate industries. Wise readers will begin to add to their lexicon terms such as “NOL,” “EBITDAR,” “RealtyRate.com,” “Loopnet.com,” and “value per square foot.”
We should keep in mind that these articles don’t necessarily offer us a defined solution, but they do provide some sunlight as we grapple with the darker issues. Importantly, any professional who attempts to appraise these types of properties without understanding current BV and RP interactions—and the multiple resources available to all appraisers or analysts—does so with a heavy risk of poor performance. For example, in valuing a location-dependent, special-use business, is the real property (or the location) the primary source of customer patronage? Is the combined business asset mix operating at its highest and best use? As our training should tell us, “follow the market” because whatever standard of value is employed—fair market value, market value, or fair value—we are trying to understand the nuances of the market participant buyer and the actual (or hypothetical) seller to develop our opinion.

Other articles in this report offer insights into how we should use the various transaction databases such as Pratt’s Stats, BIZCOMPS, and others, which typically exclude real estate value in the reported exchange price but do not adjust for implied rent expense and recalculate the multiples. Our BV databases include land-based businesses that were sold where the real property was rented, and also similar businesses sold where the real property was owned (and paid no rent). Pratt’s Stats and BIZCOMPS offer information on the rent rates, if the data was provided. Analytically, we must call owned real estate either an operating or nonoperating asset. Whichever way, some adjustment may be necessary to the transaction data for a location-dependent, special-use business. Blindly applying the transaction multiples without understanding what was sold and whether rent was paid is an invitation for criticism. In applying any transaction insights, ensure that the assets sold are similar to the assets being appraised.

For those BV types who are more accounting-oriented, there is a difference between ASC 805 allocation assignments and these types of “Main Street” business appraisals. Normally a location-dependent business is:

- Much smaller in size and typically cannot afford the level of analytical expertise of an accounting purchase price allocation assignment;
- One where other intangible assets held by equity that can be separated, licensed, exchanged, rented, or transferred (such as patents, trademarks, patient records, covenants not-to-compete, or customer contracts) are not part of the real estate value; and
- Not interested in allocation of stated intangibles for capitalization on a company’s balance sheet.

Several of the articles and cases in this book caught my eye for delivering the kind of insights that appraisers should find beneficial:

1. Mark Krickovich poses an intriguing question concerning assisted living facilities: If a sale exceeds the net tangible assets, what portion of excess cash flows are attributable to the real property and what to the intangible assets? At the risk of endorsing Revenue Ruling 68-609, are we using the excess earnings methodology properly?
2. Franz Ross, in his minicase, offers examples of appraisal myopia driven by traditional training.

3. Mandeep Sihota weighs in on funeral homes, particularly in imposing market rent expense in models treating the real property as a nonoperating asset.

4. Lynton Kotzin lays out the difficulties of appraising gas stations and convenience stores—properties that generate multiple revenue streams with different margins.

5. Adam Lawyer focuses on the valuation of an auto dealership. While car dealers may initially be considered an “all BV” type of assignment, in reality, how real estate is recorded in the financial statements can influence calculations in each of our three traditional approaches to value. Is the property overbuilt, with a loss of functionality? Is there excess land that is a nonoperating asset and could be sold off without affecting the business?

6. Alan Simons analyzes healthcare assignments, pointing out that, if real estate exists in the business, one methodology is to remove the balance sheet entries and historical cost but adjust the earnings stream for market value of rent as a cost before adding the real property to the indicated “operating” value.

7. Mark Daymon and Kari Lazarova analyze the subtle factors regarding hotels and resorts and the assumptions necessary in various methodologies to appraise them.

8. Carl Stillman shares his knowledge in valuing vineyards and winery real estate. By extension, Carl’s perceptions may be useful for other agricultural-based businesses, even though the commodity of a working farm may be less fun than sampling the goods of a winery. Carl emphasizes industry knowledge and “hard” market data as crucial elements in appraisal work.

9. The case Navigato v. SJ Restaurants, LLC (2011) is interesting because the disagreement appears between BV and RP appraisers over which discount rate to use in an economic damage model. Better data, better sources, and more relevance are the keys to persuasive arguments and winning in litigation assignments.

10. In SHC Half Moon Bay LLC v. County of San Mateo (2014), the current tug-of-war between going-concern property owners and tax assessors is laid bare in the local property taxation of a $124 million Ritz-Carlton Hotel. The central issue revolves around what to tax: real property is taxed; intangible assets are not taxed. Consequently, hotel owners want to see more value in intangible assets and pay less tax. County and state governments, in contrast, want to see more tax money coming in and are screaming that some of these “new” analytical methods undervalue the essential real estate component. This particular fight is not going away and should be an area where appraisal, accounting, and transaction intermediary professionals have an opportunity to refine our body of knowledge and practice.
After reading this horizon-expanding series of articles, what is incumbent upon each of us BV types when we find a location-dependent, special-use business assignment in our lap? Here are several takeaways:

- Communicate with our fellow RP appraisers and ensure that we don’t double-count (or double-skip) in measuring cash flows;
- Conduct a site visit/inspection of the property whenever possible;
- Interview typical buyers of the property types under scrutiny;
- Consider adjusting Pratt’s Stats, BIZCOMPS, IBA, Mid-Market Comps, and other business-oriented transaction databases for implied market rents when real property owned by the business is considered a “nonoperating asset”;
- Consider LoopNet.com, RealtyRates.com, and other real property-oriented databases;
- Ensure that we are clear on terminology in our reports, at least defining what each of our terms such as “business enterprise value” and “customer patronage” really mean;
- Recognize that our opinions of value are useful not only to the financing community, but also for ownership planning and tax matters; and
- Consider a proof-of-purchase analysis—does the summary of value components leading to an implied transaction make sense?

In short, this compendium of articles is a good read. If your appraisal/valuation assignments include smaller location-dependent, special-use businesses that operate as going concerns, you cannot afford to be out of the loop on current thinking.

Rob Schlegel, FASA, MCBA
Principal, Houlihan Valuation Advisors
Past International President, American Society of Appraisers, 2010-2011
Valuing Companies with Real Estate: Appraisal Experts Untangle the Issues
(A BVR Special Report - PDF delivery)

One of the hottest topics in the appraisal profession is the interaction of real property value and business value for going-concern properties. BVR’s special report, Valuing Companies with Real Estate: Appraisal Experts Untangle the Issues addresses the unique concerns and challenges of valuing a company with real estate. This report, with perspective from both real estate and business appraisers helps steer the profession toward a more sensible consensus.

Highlights of the Report Include:

• Two Many Cooks Might Spoil the Broth: A Case Study
• Sorting Out the Value of a Business That Owns Its Real Estate
• Allocating Value Between Intangibles and Real Estate
• Options for the Business Appraiser in Dealing with Real Estate Issues
• Every Special Purpose Property Has Its Own Unique Considerations
• Valuing Hotels and Resorts: The Real Estate Component
• Real Estate is an Important Component of an Auto Dealership Valuation
• Valuation of Investment Properties: Be Careful What You Ask For
• Valuing Vineyard and Winery Real Estate Requires Industry Knowledge
• Unique Factors That Affect the Valuation of Home Healthcare Service Firms
• Citrin Cooperman’s Funeral Home Survey Notes Stagnant Margins
• Special Issues to Consider when Valuing a Gas Station/Convenience Store
• Errors in Valuing Oil and Gas Properties in the Marcellus Shale
• Case law digests

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