Asset Allocation in Real Estate Centric Going Concerns

PRESENTER: LESLIE P. SELLERS MAI SRA
Objectives of Presentation

1. What is allocation?
2. Review of how we got here
3. Review definitions applicable
4. Review of current guidance
5. Two thought problems on allocation methodologies
6. Provide framework for moving forward
Review How We Got Here

Properties tax appeals began to focus on intangibles in the 1980’s

- Markets became more regional, national, and standardized
- Recognition that intangibles may exist is certain complex property types
- These properties drew institutional investors with specialization

Property tax case decisions in the U.S. all over the board

- Regularly quote TARE
- Looking for guidance and leadership

Appraisal Institute

- 2004 - Course 800
- 2012 - Course 830 “Fundamentals of Separating Real Property, Personal Property, and Intangible Business Assets”
Review How We Got Here

Late 1980’s the S&L Crisis resulted in Interagency Guidelines

- Bank failure reviews revealed problems & inconsistency in valuations
- Required “as is” values and no “Going Concern lending”

2012 SBA Guidelines & Requirements

- “We are receiving RE appraisers work showing no allocation of FF&E or business value when it clearly exist”
- Required certain education and testing
- 2013 Changed to B-Val only – then changed back in 2014
Review How We Got Here

USPAP

- Does not require allocation by specifically
- ASB’s FAQ is confusing on intangible allocation
- Possible complete opposite of court rulings
Allocate What?

In Real Estate “Centric” Going Concerns are Unique:

<table>
<thead>
<tr>
<th>Allocate?</th>
<th>Parts of Going Concern</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>Real Property</td>
</tr>
<tr>
<td>Typically yes</td>
<td>FF&amp;E (Personal Property &amp; Equipment)</td>
</tr>
<tr>
<td>Possible</td>
<td>Franchise, Contracts, Assembled/trained workforce</td>
</tr>
<tr>
<td>Typically NOT</td>
<td>Copyrights, Patents, Working Capital, Inventory</td>
</tr>
</tbody>
</table>
Definitions

**Going Concern:** A going concern is an established and operating business with an indefinite future life. For certain types of property (e.g., hotels and motels, restaurants, bowling alleys, manufacturing enterprises, athletic clubs, landfills), the physical real property assets are integral parts of an on-going business.


**NOTE:** Going Concern - entity description – not a value
(e.g. ‘going concern value’ in NOT an appropriate term)

- Market value of a going concern
- Market value of total assets of the business
- Market value of specified assets of the business (must specify)
Definitions

Real Property Characteristics: Items that have been installed or attached to the land or building in a permanent manner. All real estate improvements were once personal property; when attached to the land, they become real estate.

Examples:
Land
Buildings
Fixtures e.g. plumbing, lighting, HVAC, etc.

Definitions

Personal Property Characteristics: Movable items of property that are not permanently affixed to, or part of, the real estate. Personal property is not endowed with the rights of real property ownership.

Examples:
- Furniture and furnishings not built into the structure
- Equipment installed by the tenant under specific lease terms removable at end of the lease

Definitions

Intangible Asset Characteristics: Those assets that are not tangible real property, tangible personal property, or financial assets. An intangible is something that is not material, not corporeal, not substantially real.

Examples:
Franchises and licenses
Good will
Skilled workforce

Definitions

Intangible Business Value: Whenever the income to a property includes payments for goods or services other than real property rents, the property potentially includes non-real property assets that needed to be addressed appropriately. The presence of services that generate income over and above rent on the real property may create intangible property value.


Nomenclature is abundant:

Intangible Business Value …aka…Intangible Personal Property …aka…Business Enterprise Value (BEV) …aka…Enterprise Value …aka…Blue Sky …aka (more appropriate for only good will)…Business Value …aka…Economic Profit …..
Definitions

- **Total assets of the business**
  - **Tangible property**
    - Real property
    - Tangible personal property
  - **Intangible personal property**
    - Franchises and other contracts
    - Patent, trademark, copyright
    - Assembled workforce
    - Trade name
    - Residual intangible assets*
  - **Financial assets and working capital**
    - Cash
    - Marketable securities
    - Accounts receivable
    - Supplies and inventory

Allocation of Value Opinions

USPAP:

Standard Rule 1-2(e) requires an appraiser to:

Identify the characteristics of the property that are relevant to the type and definition of value and intended use of the appraisal, including;

- Any personal property, trade fixtures, or intangible items that are not real property but are included in the appraisal.

Standard Rule 1-4(g) states:

When personal property, trade fixtures, or intangibles are included in the appraisal, the appraiser must analyze the effect on value of such non-real property items.

Allocation of Value Opinions

Scope of Work Rule:

1. First, appraiser must figure out problem to solve
   a) Identify assignment elements (Through Consultation)
   b) Standard Rule 1-2(e) identification of relevant property characteristics
      (FF&E, Intangible, RE, etc.)

2. Second, determine appropriate scope of work needed to solve the problem for
   the intended use and user.

   NOTE: The scope of work is the responsibility of the appraiser according to USPAP.
Allocation of Value Opinions

USPAP – FAQ 193 - Question:

There are also occasions when the client does not specifically request separate valuations of non-real property assets, even though they may be present. Is the appraiser still required to value those assets separately?
Allocation of Value Opinions

USPAP – FAQ 193 - Answer:

No. This is a scope of work decision to be made by the appraiser; Standards Rule 1-4(g) does not require separate appraisals of these different types of assets. Some appraisers and users of appraisals believe the requirement that the appraiser must analyze the effect on value of such non-real property items in SR 1-4(g) is a requirement for the separate appraisal of those items in all assignments. That is incorrect.

Analyzing the effect on value might be appropriately made through the selection of comparable properties used in the sales comparison approach or the deduction of certain line items of expense for management fees, maintenance or replacements in the income approach, for example.
Allocation of Value Opinions

Standard Rule 1-4(g) to value versus to identify and analyze is a scope of work issue.

Appraiser must produce a “credible” work product for the intended use.

NOTE: USPAP definition of credible is “worthy of belief.”
The key is client communications…
Interagency Appraisal and Evaluation Guidelines

I. Purpose

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA) (the Agencies) are jointly issuing these Interagency Appraisal and Evaluation Guidelines (Guidelines), which supersede the 1994 Interagency Appraisal and Evaluation Guidelines. These Guidelines, including their appendices, address supervisory matters relating to real estate appraisals and evaluations used to support real estate-related financial transactions. Further, these Guidelines provide federally regulated institutions and examiners clarification on the Agencies' expectations for prudent appraisal and evaluation policies, procedures, and practices.
• Be based upon the definition of market value set forth in the appraisal regulation. Each appraisal must contain an estimate of market value, as defined by the Agencies’ appraisal regulations. The definition of market value assumes that the price is not affected by undue stimulus, which would allow the value of the real property to be increased by favorable financing or seller concessions. Value opinions such as “going concern value,” “value in use,” or a special value to a specific property user may not be used as market value for federally related transactions. An appraisal may contain separate opinions of such values so long as they are clearly identified and disclosed.

The estimate of market value should consider the real property’s actual physical
Remember USPAP FAQ 193:

“Analyzing the effect on value might be appropriately made through the selection of comparable properties used in the sales comparison approach or the deduction of certain line items of expense for management fees, maintenance or replacements in the income approach, for example.”
Allocation in General

The Appraisal of Real Estate, 14th Edition:

“For real estate intensive business properties, all three valuation approaches may be applicable. However, depending on the assignment, certain of the approaches could be less applicable to some of the asset classes, and certain approaches may be less helpful in determining an appropriate allocation of the final value opinion. Depending on the scope of work and the value being sought, the approaches may be developed to value the total property, or to isolate only the value of the real property.”
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The Valuation of a Real Estate Centric Going Concern

Includes income created by all parts
- Real Estate
- Personal Property (FF&E)
- Business Enterprise
  - Franchise & Management
  - Contracts & Trained In place Workforce
  - Other
Thought
Problem 1
Allocation

Value of Going Concern

- Business Enterprise
- FF&E
- Real Estate
Thought
Problem 1
Allocation

The Application of a “required return” to FF&E...

Issue is priority of the parts...
Thought Problem 1

Allocation

Contributing Value FF&E

Real Estate
Thought Problem 1
Allocation
Thought Problem 1
Allocation

If one part increases, the other decreases when the allocation is of total “Self-Contained” PV Allocation is contributing value of each part as it relates to total
Thought Problem 1
Allocation

Does this amount to a transfer of contributing value?
Thought Problem 1

Allocation

All Going Concern Income and Expense From FF&E, Real Estate and BEV is Considered to Obtain PV (Total). (PV is Now “Self-Contained”)

Allocation is contributing value of parts
Any Allocation with Return Added After PV is “Self Contained” requires taking from one part and giving to another. One part must suffer contributing value loss in order to “pay the required return” to another part. Priority of parts given returns must be considered.

In RE Centric Properties RE is the Highest Priority.
Thought

Problem 1

Allocation

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**Figure 29.1 Example of a cost approach addressing tangible assets only:**

<table>
<thead>
<tr>
<th>Cost Approach Summation</th>
<th>Real Property</th>
<th>Personal Property</th>
<th>Total Tangible Assets</th>
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<tr>
<td>Direct &amp; Indirect Cost</td>
<td>$2,500,000</td>
<td>$210,000</td>
<td>$2,710,000</td>
</tr>
<tr>
<td>Entrepreneurial Incentive</td>
<td>$250,000</td>
<td>--</td>
<td>$250,000</td>
</tr>
<tr>
<td>Total Replacement Cost</td>
<td>$2,750,000</td>
<td>$210,000</td>
<td>$2,960,000</td>
</tr>
<tr>
<td>Depreciation:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Physical Deterioration</td>
<td>-$600,000</td>
<td>-$42,000</td>
<td>-$642,000</td>
</tr>
<tr>
<td>Functional Obsolescence</td>
<td>-$200,000</td>
<td>$0</td>
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Thought Problem 1
Allocation

Caption under previous Cost Approach allocation example in TARE:

“This example allocates no entrepreneurial incentive to personal property. In some circumstances, appraisers conclude that entrepreneurial incentive should be allocated to all asset classes, including personal property.”
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“This example allocates no entrepreneurial incentive to personal property. In some circumstances, appraisers conclude that entrepreneurial incentive should be allocated to all asset classes, including personal property.”
Thought Problem 1
Allocation

**Entrepreneurial Incentive (Return) Here (Before)**

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**Figure 29.1 Example of a cost approach addressing tangible assets only:**

Not Here (After)
Thought Problem 1

Allocation

It’s a matter of “priority”. Which part is the most important to the total operation?

• Car wash or convenient store
• Limited service hotel
• Self storage
Thought
Problem 2
Allocation

Management Fee Method

- The deduction of a “typical management fee and franchise fee” when the property is owner managed and no franchise exist. “Isolate just the income to the real estate”.
- Does the deduction of the management fee & franchise fee remove all the business value?


Questions:

- Would the property produce more net income with management and franchise fee than without?
- If M & FF does not increase net income, why would owner purchase?
- Would the required return (discount rate) be higher on a non managed/flagged property versus one - that is (higher risk)?
Thought

Problem 2

Would without income stream be higher risk – higher discount rate?

Net Income With & Without M&FF...

Income Stream With & Without Management & Franchise

- Year 1: Income with M&FF (85,000), Income without M&FF (65,000)
- Year 2: Income with M&FF (87,500), Income without M&FF (67,500)
- Year 3: Income with M&FF (90,000), Income without M&FF (70,000)
- Year 4: Income with M&FF (92,500), Income without M&FF (72,500)
- Year 5: Income with M&FF (95,000), Income without M&FF (75,000)
- Year 6: Income with M&FF (97,500), Income without M&FF (77,500)
- Year 7: Income with M&FF (100,000), Income without M&FF (80,000)
- Year 8: Income with M&FF (102,500), Income without M&FF (82,500)
- Year 9: Income with M&FF (105,000), Income without M&FF (85,000)
- Year 10: Income with M&FF (107,500), Income without M&FF (87,500)

Linear (Income with M&FF) vs. Linear (Income without M&FF)

41
Thought
Problem 2
Allocation

Questions:

- If M&FF does increase net income, would value of the M&FF not be more than the cost?
- Does this amount to a “rule of thumb” methodology? (i.e. black box or equivalent to the 25% rule methodology? “Daubert”)
Proposed Solutions

◦ Develop Best Practices as Guidance
  ◦ Rights supported by contracts versus real property generally have higher risk (all other things the same)
  ◦ Investment premise requires return on and return of the investment
  ◦ Going concern premise means allocation is contributing value of the whole versus independent market value for each part
  ◦ Method used for allocation should pass test of reasonableness and more than one method used and reconcile when possible
  ◦ No black boxes methods and no rules of thumb (Daubert)
  ◦ Each property analyzed independently based on merits
  ◦ Professional responsibility for proper application of the methodology
Final Conclusion

“It ain’t over yet”