Going Concern Forum
Valuation Issues in Appraising
Realty and Non-Realty Components
7. If the appraisal engagement letter asks the appraiser for a business enterprise or going concern value, the appraiser must allocate separate values to the individual components of the transaction including land, building, equipment and business. When the collateral is a special purpose property, the appraiser must be experienced in the particular industry.
Going Concern Appraisals

Interagency Guidelines released December 2010:

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.
Overview

1. Guidance
2. Definitions
3. Types of Real Estate Assets with Realty and Non-realty components
4. Overview of non-realty components
5. Guidance on Going Concern Valuation
6. Appraiser encounters with going concern and non-realty valuations
   - Lending
   - Ad Valorem taxation
   - Eminent Domain
   - Estate Valuation
7. Divisions and Allocations
1. Guidance

Guide Note 5 & USPAP
Going Concern Appraisals
Guide Note 5

Guide Note 5
Appraisals of Real Estate with Related Personal Property, Business Property or Intangible Assets

effective May 6, 2011
• The **valuation of personal property, business property, or intangible assets requires specific expertise.**

• **Before accepting an appraisal or appraisal review involving such assets, an appraiser must ascertain that she or he has the expertise to complete the assignment competently.**

• The **expertise of a personal property or business appraiser may be needed in some cases.**
In developing a real property appraisal, appraisers are required by S.R. 1-2(e) (iii) to identify "any personal property, trade fixtures, or intangible items that are not real property but are included in the appraisal."

S.R. 6-2(g) (ii) makes the same requirement regarding mass appraisals.
USPAP

• S.R. 1-4(g) requires that when the scope of work warrants such analysis, the appraiser must analyze the effect on value of any personal property, trade fixtures, or intangible items that are not real property but are included in the appraisal.

• The Comment to S.R. 1-4(g) states: When the scope of work includes an appraisal of personal property, trade fixtures or intangible items, competency in personal property appraisal (see STANDARD 7) or business appraisal (see STANDARD 9) is required.

• See USPAP FAQ 164, FAQ 224 & FAQ 225
Guide Note 5 offers detailed identification and guidance on:

- Personal Property
- Business Property
- Intangible Assets Relating to Going Concerns
Summary of Standard Practices

1. Develop an appraisal of real estate and related personal property only after ascertaining adequate knowledge and experience to complete the assignment competently (Competency Rule).

2. Identify any personal property, trade fixtures, or intangible items that are not real property but are included in the appraisal (S.R. 1-2(e) (iii)). Analyze the effect on value of any personal property, trade fixtures, or intangible items that are not real property but are included in the appraisal, when the scope of work for the assignment warrants such analysis (S.R. 1-4(g)).

(Please Note: The purpose of the Guide Notes to the Standards of Professional Appraisal Practice is to provide Members with guidance as to how the requirements of the Standards may apply in specific situations.)
2. Definitions

Definition of Market Value

Going Concern

Business Enterprise Value

Going Concern Premise

Real Property

Personal Property

Intangible Assets
Going Concern Appraisals
Definitions


Market Value is defined as follows:

The most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specific date and the passing of title from seller to buyer under conditions whereby:
1) Buyer and seller are typically motivated;
2) Both parties are well informed or well advised, and acting in what they consider their own best interests;
3) A reasonable time is allowed for exposure in the open market;
4) Payment is made in terms of cash in US dollars or in terms of financial arrangements comparable thereto; and
5) The price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.
Real Property

“the interests, benefits, and rights inherent in the ownership of real estate.”

2010-2011 USPAP
Personal Property

“identifiable tangible objects that are considered by the general public as being “personal” – for example, furnishings, artwork, antiques, gems and jewelry, collectibles, machinery and equipment; all tangible property that is not classified as real estate.”
Intangible Assets

“nonphysical assets, including but not limited to franchises, trademarks, patents, copyrights, goodwill, equities, securities, and contracts, as distinguished from physical assets such as facilities and equipment.”

2010-2011 USPAP
Going Concern

A going concern is a business having the ability to continue functioning as a business entity in the future. In accounting, a business is considered to be a going concern if it is likely to continue functioning 12 months into the future.

Going Concern Premise

One of the premises under which the total assets of a business can be valued; the assumption that a company is expected to continue operating well into the future (usually indefinitely). Under the going-concern premise, the value of the tangible assets and the value of the intangible assets, which may include the value of excess profit, where asset values are derived consistent with the going-concern premise.

Business Enterprise Value

The value contribution of the total intangible assets of a continuing business enterprise such as marketing and management skill, an assembled workforce, working capital, trade names, franchises, patents, trademarks, contracts, leases, customer base, and operating agreements.

3. Types of Real Estate Assets with Realty and Non-realty components
Total Assets of a Business (TAB) can include:

<table>
<thead>
<tr>
<th>Real Property</th>
<th>FF&amp;E (Personal Property)</th>
<th>Intangibles</th>
</tr>
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<tbody>
<tr>
<td>Land</td>
<td>Furniture in rooms &amp; public areas</td>
<td>Cash and equivalents (often partially excluded) AKA working capital</td>
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</tr>
<tr>
<td></td>
<td>Computer systems</td>
<td>Trademarks, copyrights and patents</td>
</tr>
<tr>
<td></td>
<td>Inventory</td>
<td>Name and goodwill</td>
</tr>
</tbody>
</table>

All together are referred to as the Total Assets of the Business (TAB). However, one or more components is often excluded from the valuation.
Going Concern Appraisals
Property Types

**Hotels**

**Motels**

**Time-share resorts**
Going Concern Appraisals
Property Types

- Convenience stores
- Quick Serve Restaurant
- Full Serve Car Wash
Going Concern Appraisals
Property Types

Athletic Clubs
Bowling Alley

Golf Course
Going Concern Appraisals

Property Types

• Seniors Housing
  o Independent Living Facilities
  o Assisted Living Facilities
  o Skilled Nursing Facilities
  o CCRC's (Continuing Care Retirement Communities)
Going Concern Appraisals
Property Types

Surgical Centers
Hospitals
Examples of properties with Realty and Personal Property Components
Going Concern Appraisals
Property Types

Gasoline Stations
Educational Facilities
Power Plants
Specialized Manufacturing
Bank Branches
<table>
<thead>
<tr>
<th>Generally Have Business Considerations</th>
<th>Gray Area</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lodging</td>
<td>Regional mall</td>
</tr>
<tr>
<td>Hospitals, Surgical Facilities</td>
<td>Self-Service or “Laser” Car Wash</td>
</tr>
<tr>
<td>Seniors Housing</td>
<td>Student Housing</td>
</tr>
<tr>
<td>Restaurants</td>
<td>Self-Storage facility</td>
</tr>
<tr>
<td>Convenience Store</td>
<td></td>
</tr>
<tr>
<td>Full Service Car Wash</td>
<td></td>
</tr>
<tr>
<td>Bowling Alley</td>
<td></td>
</tr>
<tr>
<td>Lube Center</td>
<td></td>
</tr>
<tr>
<td>Golf Course</td>
<td></td>
</tr>
<tr>
<td>Marina</td>
<td></td>
</tr>
<tr>
<td>Day Care Center</td>
<td></td>
</tr>
</tbody>
</table>
4. Overview of non-realty components
Total Assets of a Business (TAB) can include:

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</table>

All together are referred to as the Total Assets of the Business (TAB). However, one or more components is often excluded from the valuation.
Leasehold improvements

Specific build-out for use by a tenant, constructed on-site rather than merely installed (or modified and installed).
Trade Fixtures and Domestic Fixtures

- installed by or for occupants who at conclusion of occupancy may forfeit them, sell them, remove them or abandon them.
- Domestic fixtures are typically window treatments
5. Guidance on Going Concern Valuation
Guide Note 5

**Business Property/Intangible Assets Relating to Going Concerns**

- A going concern is an established and operating business with an indefinite future life.
- Physical real estate assets are integral part of ongoing business
- Laymen's terms: "going concern value", "business value" or "business enterprise value"
- More accurate terminology is "value of the going concern", including real property, personal property, and the intangible assets of the business
Guide Note 5

Business Property/Intangible Assets Relating to Going Concerns

• The value of the going concern includes the incremental value associated with the business operation, which is distinct from the value of the real property.
• The value of the going concern includes intangible enhancement of the value of the operating business enterprise, which is produced by the assemblage of
  ▪ land
  ▪ buildings
  ▪ labor (including trained workforce)
  ▪ equipment
  ▪ marketing operation
Guide Note 5

Business Property/Intangible Assets Relating to Going Concerns

- Appraisers often called upon to develop and opinion of the investment value, use value, or some other type of value of a going concern, but most appraisals of going concerns require a "market value of the going concern".
- Appraisers should be careful that he or she has the competency to complete this type of valuation assignment.
- It may be necessary for the real property appraiser to collaborate with a personal property appraiser or a business appraiser or both on such an assignment *

* See USPAP FAQ 225
Guide Note 5

Division of Realty and Non-realty Components

• May be required given the intended use of the appraisal
• Examples
  ▪ ad valorem taxation
  ▪ eminent domain
  ▪ real estate lending
• Appraiser must ascertain whether the assignment calls for a mere allocation of the value of the entirety among the various components, or
• whether value opinions are to be developed separately for each component
Guide Note 5

Division of Realty and Non-realty Components

• if value opinions are developed separately for each component, careful consideration must be given to the type and definition of value being used in each case.

• the type and definition needs to be appropriate for the intended use, but also needs to be appropriate for the asset type
Guide Note 5

Division of Realty and Non-realty Components

• the intangible assets would not have a "market value" separate from the entirety if they could not be marketed separately

• the values of the various assets upon liquidation could be quite different from the values of those assets as part of the on-going business operation

• These issues must be considered carefully when identifying the problem to be solved by the assignment
6. Areas where appraisers may encounter requirements to segregate or value separately components of value
(7) If the appraisal engagement letter asks the appraiser for a business enterprise or going concern value, the appraiser must allocate separate values to the individual components of the transaction including land, building, equipment and business. When the collateral is a special purpose property, the appraiser must be experienced in the particular industry.
Interagency Real Estate Appraisal and Evaluation Guidelines

• Took effect December 10, 2010
• Apply to all institutions regulated by:
  o Office of the Comptroller of the Currency
  o Board of Governors of the Federal Reserve System
  o Federal Deposit Insurance Corporation
  o Office of Thrift Supervision
  o National Credit Union Administration
Interagency Guidelines state:

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.
Interagency Guidelines for Real Estate Lending Policies:
12 CFR part 365; 12 CFR part 208, subpart E, 12 CFR part 34, subpart D; and 12 CFR 563.100-101

Loan-to-value or loan-value ratio means the percentage or ratio that is derived at the time of the loan origination by dividing an extension of credit by the total value of the property(ies) securing or being improved by the extension of credit plus the amount of any readily marketable collateral and other acceptable collateral that secure the extension of credit. Other acceptable collateral means any collateral in which the lender has a perfected security interest, that has a quantifiable value, and is accepted by the lender in accordance with safe and sound lending practices. Other acceptable collateral should be appropriately discounted by the lender consistent with the lender's usual practices for making loans secured by such collateral.
Other mentionable guidance on this issue from the agencies: OTS Regulatory Bulletin RB 37-30

"Assisted living facilities are real estate with a business component."

"Hotels and Motels... there is less income stability compared with other types of real estate."
American Banker Viewpoint Article Feb. 4, 2005
authored by Kathleen W. Collins and Zonnie Breckenridge

A Business Real Estate Appraisal Problem

- When does market value not equal market value?
- When does the “value” as in “loan to value” mean something less than the bank thought it did?

- Article brings to light discussions back in 2004 from the regulators expressing the viewpoint to structure going concern real estate loans with separate terms for Real Estate, Personal Property and Intangible Assets
• How are lenders handling the 2010 Interagency Guidance?

• Potential issues
  ▪ Has this created an unlevel playing field based on interpretation of the IAG?
  ▪ Will this impact LTV calculations on existing loans?
  ▪ Will this restrict lending?
  ▪ Will this increase the cost of lending?
  ▪ If a loan is structured separately between real estate and non-real estate components, what happens if one loan goes into default?
• Market Value premise

- If the property is a recognized real estate asset class, readily marketed and sold as a TAB by participants subject to market influences for income production, is this truly an issue and is it necessary to separately value or allocate other value components?
- What about a nursing home where rates are set by a regulatory body, with little to no consideration given to market rates?
Some lenders have interpreted the Guidelines to mean that the real estate must be valued on a liquidation premise.

If real estate only values are used, achievable loan to values for new loans will fall.

If existing loans are re-valued on a real estate only basis, many existing loans will be under water.

There is a lack of consensus within the appraisal community on how to provide real estate only values for assets operated on a going concern basis, so the use of real estate only values will result in a non-level playing field.
• Remember:
• USPAP states, S.R. 1-4(g) requires that when the scope of work warrants such analysis, the appraiser must analyze the effect on value of any personal property, trade fixtures, or intangible items that are not real property but are included in the appraisal.
• Interagency Guidelines state “An appraisal may contain separate opinions of such values so long as they are clearly identified and disclosed.”
• Most tax jurisdictions apply separate tax rates for real estate and personal property and are silent on Business Value.
• It is important to understand when a real estate appraiser is qualified to render an opinion on non-realty items particularly in tax appeal proceedings.
• In most cases an owner may show loss of profits as an injury to business, not as a separate item of damage, but as affecting the market value of the remaining land and improvements.

• Some states have enacted condemnation legislation to compensate for a loss of a going concern if the business is destroyed by the taking, including compensation to lessees and compensation for goodwill.
Loss of business profits is, under federal law, noncompensable. Congress has provided for recovery of some business losses by adopting the Uniform Relocation Assistance and Real Property Acquisition Act of 1970….it is important that appraisers exclude such consequential damages from consideration in developing their estimates of market value.
• States have varying definitions of what constitutes real property, personal property and intangible interests.
Economic Loss Approach

Awards condemnees the loss of the economic value of their property, measured by lost profits or “going concern value.” Typically, a business is not considered to be property covered under the Fifth Amendment’s protection, particularly in consequential damage (unless temporary taking or public use of the business itself) and is only recognized as a factor in determining market value of the property. Courts are often prudent in adhering to the flexible approach to valuation damages, while not endorsing lost profits as a common method of valuation but citing lost profits as a measurement of value.
• US Supreme Court has determined that market rental value is the most appropriate approach for valuing temporary takings involving business losses because the condemnee is the value of the use of the premises during the taking, which normally is determined by its market rental value. However, the rental value may not always provide just compensation in situations in which “a greater interest, in fact, has been taken”
Uniform Appraisal Standards for Federal Land Acquisitions

- Silent on Going Concern Premise
- B-7. Income Capitalization Approach may be relevant (only income generated by the real estate – normally rental income, and not income generated from a business conducted on the property)
  - “not income produced from a business enterprise conducted on the property”
  - “there should be no incremental value for loss of the business or its profits”
• “Therefore, when valuing property that typically sells on the basis of income production, it is appropriate to consider the amount of business conducted on the site”

• “Property having a highest and best use for mineral production may be appraised by an income approach. This is not, however, an approach that should be used by an appraiser who is not thoroughly experienced in appraising mineral deposits”
IRS

- Internal Revenue Bulletin 2006-96
- Transitional Guidance
- Section 3
- (2) Generally accepted appraisal standards. An appraisal will be treated as having been conducted in accordance with generally accepted appraisal standards within the meaning of § 170(f)(11)(E)(i)(II) if, for example, the appraisal is consistent with the substance and principles of the Uniform Standards of Professional Appraisal Practice (“USPAP”), as developed by the Appraisal Standards Board of the Appraisal Foundation. Additional information is available at http://www.appraisalfoundation.org.

- (a) For real property
- (i) For returns filed on or before October 19, 2006, the appraiser is qualified as a “qualified appraiser” within the meaning of § 1.170A-13(c)(5) to make appraisals of the type of property being valued.
- (ii) For returns filed after October 19, 2006, the appraiser is licensed or certified for the type of property being appraised in the state in which the appraised real property is located.
IRS (continued)

• (b) *For property other than real property* —
  • (i) For returns filed on or before February 16, 2007, the appraiser is qualified as a “qualified appraiser” within the meaning of § 1.170A-13(c)(5) to make appraisals of the type of property being valued.
  • (ii) For returns filed after February 16, 2007, the appraiser has (A) successfully completed college or professional-level coursework that is relevant to the property being valued, (B) obtained at least two years of experience in the trade or business of buying, selling, or valuing the type of property being valued, and (C) fully described in the appraisal the appraiser’s education and experience that qualify the appraiser to value the type of property being valued.
7. Allocations
• Possible Scenarios to value the TAB
  o As a Going Concern, which assumes that the business will continue to operate into the future
  o Under a liquidation premise assuming the business ceases to operate
• Generally, the value of a business is higher when valued as a going concern.
• But if the sum of the component values is higher than the value as a going concern, then the liquidation premise should be used.
• May set basis for lending under new Interagency Appraisal Guidelines
• Often used to establish value of taxable components for ad valorem tax assessment
• Often used to establish values for condemnation
• Often used to establish allocations for accounting purposes.
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Going Concern Appraisals
Real Estate Only Values

- Providing real estate only values for going concerns is problematic, because
  - The highest and best use of such assets is generally to continue operations as a going concern. So valuing the real estate only assumes going concern operations, and has inherent in it the success of the business.
  - The real estate alone is often not saleable on its own.
  - Gray areas relating to what is real estate and what is not. Example is a Certificate of Need for a nursing home.
  - Lack of consensus on appropriate methodology to provide real estate only valuations
There are two ways to look at the real estate in a going concern:

- Based upon continued operation of the property as part of a going concern. So, this is really an allocation, and probably should be stated as such.
- Based upon liquidation of the business, which implies a change in highest and best use and will generally result in steep discount to the real estate only value.

The Interagency Guidelines are silent as to which is appropriate.

To avoid confusion, appraisers should carefully word the reported values, for example:

- “Allocated market value of the real estate only based upon continued operation of the business enterprise”
- “Market value of the real estate only based upon a liquidation of the business”
Allocation of a $3,000 Monthly Assisted Living Fee

- Health Care ($700)
- Activities & Transportatic ($400)
- Housekeeping ($400)
- Food ($50)
- Utilities ($200)
- Housing Ren ($800)

Fees Relating to Services

Fees Relating to Real Estate
**Going Concern Appraisals**

**Nursing Home Example**

**Going Concern Premise**
- Land, $500,000
- Intangibles, $5,000,000
- Building, $9,000,000
- FF&E, $350,000
- CON, $600,000
- FF&E, $700,000

**Liquidation Premise**
- Intangibles, $-
- CON, $600,000
- Land, $500,000
- Building, $4,000,000
<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Market Value of the Going Concern (AKA TAB)</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Less Market Value of the Site As Though Vacant</td>
<td>-$1,000,000</td>
</tr>
<tr>
<td>Less Depreciated Value of Improvements Via the Cost Approach</td>
<td>-$7,000,000</td>
</tr>
<tr>
<td>Less Depreciated Value of the FF&amp;E Via the Cost Approach</td>
<td>-$500,000</td>
</tr>
<tr>
<td>Remainder, Allocated to Intangibles</td>
<td>$1,500,000</td>
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**Value Allocation Methods**

**Cost/Residual Method**

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<td>$1,500,000</td>
</tr>
</tbody>
</table>

- Applied by estimating total going concern value via the income and sales comparison approaches, then deducting depreciated cost of real estate and FF&E. The remainder is allocated to intangibles.
- Easy to apply, easy to understand
- Estimating cost and depreciation may be difficult.
- No recognition of the relative performance of the business
• Apply by estimating value of real estate and FF&E based upon market rent for real estate & FF&E. The remainder is allocated to intangibles.
• For a full service hotel, the market rent might be based upon the sum of rents for the various departments.
• For this method to work, there must be active market to obtain rental and capitalization rate data.
• Market rent may consider relative performance of the business operation.

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<tr>
<td>Market Rent Attributable to the Real Estate &amp; FF&amp;E</td>
<td>$800,000</td>
</tr>
<tr>
<td>Capitalization Rate Applicable to Real Estate &amp; FF&amp;E</td>
<td>9%</td>
</tr>
<tr>
<td>Indicated Value of Real Estate &amp; FF&amp;E</td>
<td>$8,888,889</td>
</tr>
<tr>
<td>Remainder, Allocated to Intangibles</td>
<td>$1,111,111</td>
</tr>
</tbody>
</table>
In this method, annual income and an appropriate capitalization rate are assigned to each component, and each component is valued separately with the going concern being the total of the components.

The primary shortcoming of this technique is that while it is technically correct, it is generally not possible to extract the various inputs needed from the market.

<table>
<thead>
<tr>
<th>Component</th>
<th>Income Attributable to Component</th>
<th>Cap Rate Attributable to Component</th>
<th>Allocated Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real Estate</td>
<td>$700,000</td>
<td>8.0%</td>
<td>$8,750,000</td>
</tr>
<tr>
<td>FF&amp;E</td>
<td>$100,000</td>
<td>20.0%</td>
<td>$500,000</td>
</tr>
<tr>
<td>Intangibles</td>
<td>$200,000</td>
<td>25.0%</td>
<td>$800,000</td>
</tr>
<tr>
<td>Totals</td>
<td>$1,000,000</td>
<td></td>
<td>$10,050,000</td>
</tr>
<tr>
<td>Rounded</td>
<td></td>
<td></td>
<td>$10,000,000</td>
</tr>
</tbody>
</table>
In this method, the total value of the going concern is calculated with NO deductions for management fees and franchise fees. The Business Enterprise Value is then calculated based upon the capitalized value of the management fee and franchise fee.

The BEV value, other intangibles, and FF&E are then deducted to get to the real estate only value.

Some argue that there is additional BEV inherent in the EBITDA, and that this method does not fully account for the appropriate amount of BEV.
Going Concern Appraisals

Summary

- USPAP (Guide Note 5)

- Know the rules in your area of work, as well as clearly define Scope of Work with your client

- Different methods of Allocation may provide significant variations
Going Concern Appraisals

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