The Total Excess Earnings Model Revisited—It’s Not Just for Going Concerns
by Franz H. Ross, MAI, and Larry Woodall

Abstract
A valuation assignment for a nonstabilized property with three property types, including a going concern, is a difficult assignment. The total excess earnings model (TEEM), however, can be a big part of the solution. Users of TEEM should recognize that the asset allocations will be better supported if TEEM is used mostly as a reconciliation tool, with the user of the model making just a few calculations. The nature of intangible assets (and especially the value of the assembled workforce) is a topic needing analysis, especially considering the challenges businesses have faced maintaining a workforce in the wake of the COVID-19 pandemic. This article analyzes the importance of the strength of the going concern occupant and proposes that a property with a credit tenant is superior to a similar property receiving similar rent from a non-credit tenant. Similarly, a property occupied by a strong and consistently profitable going concern is superior to one with a weaker going concern. While some appraisers will argue that the higher real estate value of a successful going concern is a use value (as many appraisers believe there to be only one possible fee simple value), a strong going concern must sell as a going concern (or as a sale leaseback) based upon the principle of highest and best use. The superiority of the stronger going concern logically is apparent in the value of the real estate, personal property, and intangible assets.

† Note that portions of this article are at variance with the Appraisal Institute's published body of knowledge, specifically the allocation of intangibles. Inclusion of reasonable but alternative perspectives is consistent with the mission of The Appraisal Journal as a forum for ideas. Readers are encouraged to consult The Appraisal of Real Estate, 17th edition, and form their own opinions.

total excess earnings model’s strengths is its flexibility. There is no single order for placing inputs into the model. The display for the model includes a column for each asset with three rows: the top row for value of the asset \( V \), the second row for allocation of income \( I \), and the third row for income divided by the value, also known as a capitalization rate \( R \). The income allocations start with total earnings before interest, income taxes, depreciation, amortization, and net rent for the going concern (GC) less a capital reserve, resulting in net EBITDAR,\(^{4}\) which is quite similar to net operating income (NOI) used to capitalize various property types.

Revisiting TEEM is of interest to further develop allocation issues raised in the 2020 Appraisal Journal article “Perspectives on the Assembled Workforce in Real Property Valuation.”\(^{5}\) The current article acknowledges that some intangible assets—such as the assembled workforce—are not valued based on capitalized excess earnings, while goodwill is. The COVID-19 pandemic increased the value of the assembled workforce for viable businesses as the pandemic caused an unprecedented wave of layoffs. The unemployment rate subsequently improved, but an unintended consequence of the government’s stimulus support was difficulty for businesses to find enough staff to operate, despite wage increases—in some cases increases of 20% or more. The difficulty in keeping businesses fully staffed continued even as the pandemic receded.

While the value of the workforce has increased, the question remains as to what is its value. The discussion here proposes an estimation formula for use until a future source can provide market evidence of the assembled workforce’s value. In this way, the discussion is a counterpoint to that in “Perspectives on the Assembled Workforce in Real Property Valuation,” and it suggests a more moderate solution to the workforce value quandary.

### TEEM Case Study

#### Cash Flow Analysis of Marina with Multiple Property Types

The example that follows is based upon a real appraisal problem. Numbers and aspects of the going concern have been changed for confidentiality. The property to be appraised consists of a marina with 110 slips located in a bay. There is a marina store with boat showroom, one service bay, and marina office. The 18,000-square-foot mixed-use building has restrooms and showers for the marina’s clients, limited showroom space within its 5,000 square feet of rentable building area, and 3,000 square feet of rentable office space on the first floor. There are 10 small apartments located on the 9,000-square-foot second floor. The property is currently not stabilized due to a transition in management. For this reason, a two-year cash flow analysis has been performed, with Year 2 representing stabilized income and expense. Both years’ net earnings before interest, taxes, depreciation, and amortization plus rent (net EBITDAR) are discounted at the 9.5% discount rate for one year, with it being the end of Year 1 and forward looking as of day one of Year 2. Exhibit 1 shows the cash flow analysis for the marina with its showroom, offices, and apartments.

Note that in the cash flow analysis no selling expenses have been subtracted after capitalizing the Year 2 net EBITDAR, as this analysis is considered to represent a delayed direct capitalization. The 8.75% capitalization rate and the 9.5% discount rate were selected after reviewing data from surveys for apartments, office space, and marinas and giving appropriate weight to each property type. The inventory necessary to achieve the boat sales is also included in the going concern value.

With the Year 2 net EBITDAR forecast at $668,172, and the cash flow analysis concluding a value of $7,400,000 (including inventory), the calculated capitalization rate based on Year 2 net

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4. For a discussion of EBITDAR, see Franz H. Ross and James K. Tellatin, “Asset Allocations: Are You Reconciling?” The Appraisal Journal (Summer 2015): 533–537. The Ross and Alessi article “Using TEEM-Work to Extend Your Reach” presents an example of an owner-occupied restaurant with allocations made to real estate, furniture, fixtures, and equipment (FF&E), and intangible business value, with the sum of the assets being the total value of the going concern. Readers may want to review the example in “Using TEEM-Work to Extend Your Reach” before digesting the more complex case study for multiple property types that is presented here.

## Exhibit 1 Cash Flow Analysis for Marina with Showroom, Offices, and Apartments

<table>
<thead>
<tr>
<th></th>
<th>Appraisal Pro Forma Marina, Apts, &amp; Office</th>
<th>Appraisal Premise</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Pro Forma Year 1 ($ 000's)</td>
<td>Pro Forma Year 2 ($ 000's)</td>
</tr>
<tr>
<td></td>
<td>($ 000's)</td>
<td></td>
</tr>
<tr>
<td>1. Slip &amp; Dock Income</td>
<td>273,408 8.7%</td>
<td>341,760 9.0%</td>
</tr>
<tr>
<td>2. Boat Sales</td>
<td>2,550,000 81.1%</td>
<td>3,000,000 79.3%</td>
</tr>
<tr>
<td>3. Boat Service</td>
<td>129,600 4.1%</td>
<td>180,000 4.8%</td>
</tr>
<tr>
<td>4. Apartment Rent</td>
<td>150,144 4.8%</td>
<td>187,680 5.0%</td>
</tr>
<tr>
<td>5. Office Rent</td>
<td>40,656 1.3%</td>
<td>73,920 2.0%</td>
</tr>
<tr>
<td>6. Total Revenue</td>
<td>3,143,808 100%</td>
<td>3,783,360 100%</td>
</tr>
<tr>
<td>7. Cost of Goods Sold</td>
<td>2,123,400 67.54%</td>
<td></td>
</tr>
<tr>
<td>8. Gross Profit</td>
<td>1,020,408 32.46%</td>
<td></td>
</tr>
<tr>
<td>9. Operating Expenses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10. Owner's Mgmt. Fee</td>
<td>94,314 3.0%</td>
<td>113,501 3.0%</td>
</tr>
<tr>
<td>11. Salaries &amp; Wages</td>
<td>218,500 7.0%</td>
<td>230,000 6.1%</td>
</tr>
<tr>
<td>12. Property Taxes</td>
<td>50,000 1.6%</td>
<td>51,520 1.4%</td>
</tr>
<tr>
<td>13. Insurances</td>
<td>32,000 1.0%</td>
<td>32,640 0.9%</td>
</tr>
<tr>
<td>14. Advertising</td>
<td>12,000 0.4%</td>
<td>12,360 0.3%</td>
</tr>
<tr>
<td>15. Credit Card Fees</td>
<td>31,438 1.0%</td>
<td>37,834 1.0%</td>
</tr>
<tr>
<td>16. Utilities</td>
<td>42,000 1.3%</td>
<td>48,300 1.3%</td>
</tr>
<tr>
<td>17. Repairs/Maint.</td>
<td>24,000 0.8%</td>
<td>25,200 0.7%</td>
</tr>
<tr>
<td>18. Gen. &amp; Admin., Misc.</td>
<td>20,000 0.6%</td>
<td>21,000 0.6%</td>
</tr>
<tr>
<td>19. Total Operating Exp.</td>
<td>524,252 16.7%</td>
<td>572,354 15.1%</td>
</tr>
<tr>
<td>20. EBITDAR</td>
<td>496,156 15.8%</td>
<td>706,006 18.7%</td>
</tr>
<tr>
<td>21. Capital Reserve</td>
<td>31,438 1.0%</td>
<td>37,834 1.0%</td>
</tr>
<tr>
<td>22. Net EBITDAR</td>
<td>464,718 14.8%</td>
<td>668,172 17.7%</td>
</tr>
</tbody>
</table>

### A Capitalization Rate
- **8.75%**

### B Capitalized Value
- **$7,636,251**

### C Cash Flow to Be Discounted
- **$464,718**

### D Discount Rate
- **9.50%**

### E Present Value Factor
- **0.9132**

### F PV of Cash Flow
- **$424,400**

### G "As Is" Value
- **$7,398,145**

**Rounded:** **$7,400,000**
EBITDAR is as follows: $668,172/$7,400,000 = 9.03%. Note that the impact of capitalizing in Year 2 adds 28 basis points to the 8.75% capitalization rate used to capitalize Year 2 net EBITDAR. TEEM will allocate the income and value to the three property types (and other assets) and will confirm that an appropriate overall capitalization rate and discount rate were selected. It is acknowledged that appraisal is an iterative process. TEEM is presented in the following discussion and then further explained and displayed in Exhibit 2.

### TEEM Analysis Steps for Marina Example

**Inputs for Going Concern with Inventory.** With the inputs for the going concern with inventory as shown in Exhibit 1, the Year 2 pro forma net EBITDAR of $668,172 is divided by the concluded value for the cash flow analysis, which is $7,400,000. The capitalization rate is 9.03%. It is important to recognize that this is categorized as a going concern because of the marina, but it is otherwise not a going concern property, with the office space and apartments adding two non-going concern property types.

**Boat and Service Department Inventory.** Based on historical performance and research of other marinas, the inventory should turn over every 120 days or three times per year. The cost of boats sold in Year 2 is 82% of $3,000,000 in boat sales, or $2,460,000. The estimated cost of parts used in the service department is 25% of $180,000 service income, or $45,000. The summed cost of goods sold, $2,505,000, is multiplied by 33.3%, representing the 120-day turnover, resulting in inventory of $830,000 (rounded). Interest rates charged by floor plan lenders are currently low, in the range of 2.5%. There is judged to be greater risk than indicated by the interest rate. A pre-

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**Exhibit 2** Total Excess Earnings Model: Marina Case Study

<table>
<thead>
<tr>
<th>Exhibit 2</th>
<th>Total Excess Earnings Model: Marina Case Study</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Real Estate:</strong></td>
<td><strong>Intangible Assets</strong></td>
</tr>
<tr>
<td><strong>Real Estate:</strong></td>
<td><strong>Real Estate:</strong></td>
</tr>
<tr>
<td><strong>10 Apartments</strong></td>
<td><strong>3,000 SF Office</strong></td>
</tr>
<tr>
<td>$2,320,000</td>
<td>$480,000</td>
</tr>
<tr>
<td><strong>1A</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Net EBITDAR</strong></td>
<td>$121,992</td>
</tr>
<tr>
<td><strong>2A</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Capitalization Rate</strong></td>
<td>5.25%</td>
</tr>
<tr>
<td><strong>3A</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Sales Comparison Indicated</strong></td>
<td>$232,000</td>
</tr>
<tr>
<td><strong>4A</strong></td>
<td></td>
</tr>
</tbody>
</table>

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mium is added, with an adopted inventory capitalization rate of 4%. Multiplying the inventory value by the inventory capitalization rate ($830,000 × 4%) results in an income allocation for the inventory of $33,200.

**Total Permanent Assets of the Going Concern.** The inventory value of $830,000 is subtracted from the going concern value inclusive of inventory, and the result of $6,570,000 is the value of the permanent assets. Sales of such going concerns can be inclusive or exclusive of inventory. (Both occur in arm’s-length marina sales.) The income allocation to the inventory, $33,200, is next subtracted from the Year 2 net EBITDAR, making the remaining net EBITDAR for the permanent assets $634,972. The capitalization rate for the permanent assets is found by dividing the income by the value and is 9.66%.

**FF&E.** While there may be a nominal amount of FF&E in the marina property’s office building, the entire allocation for FF&E is attributed to the marina. The value of the FF&E was found using balance sheet data for equipment costs and includes three boats in a rental fleet. Depreciation is estimated at rates slightly lower than used for accounting depreciation. The concluded FF&E cost approach value is $170,000. Due to the lesser durability of FF&E compared to real estate, its income is calculated based upon a relatively short ten-year life, with monthly loan payments on a fully amortized $170,000 loan over ten years at 9% interest. The monthly payment is $2,153.49 and the annual debt service is $25,842, which is the income for the FF&E. Dividing the income by the $170,000 value results in a capitalization rate of 15.2%.

**Intangible Assets.** Generally, a small office and apartment building are not considered to include intangible assets, and that conclusion is made here. The presence of three property types within the same property, however, could create an intangible. If an intangible exists for the synergies of having the three property types together, it would be a modest asset. A small part of the intangibles could be allocated to the workforce necessary to operate the office space and apartments; this too would be a very small intangible. For simplicity, this analysis will assume the intangible assets are all attributed to the marina and boat dealership. Marinas that sell boats have a greater business component than marinas that only rent slips. There should be, and is, intangible value at the subject. In particular, the intangibles at the subject consist of four assets: (1) assembled workforce, (2) name/brand and website, (3) franchise/dealership agreement, and (4) customer list/goodwill (the true residual intangible).

The total intangibles are the residual in this model, and value is found by subtracting the real estate and FF&E values from the value of the permanent assets, which is $6,570,000. The real estate inputs are presented in detail in the discussion that follows. A cost approach was done for the entire property as described, and the resulting value for the total real estate (with three property types) is $5,730,000. Subtracting the real estate and FF&E values from $6,570,000 results in an intangible assets value of $670,000.

Next, a capitalization rate is selected for the intangibles. Reasonable calculations put the FF&E capitalization rate at 15.2%. Typically, a 500- to 1,000-basis point premium above the FF&E rate is applicable for the intangible assets. Most intangible assets either cannot be sold separately or seldom are sold separately, and the reduced marketability aspect of these assets naturally results in a capitalization rate premium over more-marketable assets such as FF&E. Furthermore, intangible asset capitalization rates can be extracted from sales of businesses in DealStats and other business valuation databases. Such databases generally indicate intangible assets net EBITDAR–based capitalization rates of 15% to 40% (a very wide range). Real estate–related (e.g., waterfront) businesses should be near the low end of the range. A 20% capitalization rate is therefore selected. The residual income (also known as excess earnings) is found by multiplying the already concluded $670,000 value by the 20% capitalization rate. The excess earnings are therefore $134,000.

**Total Real Estate Value.** The real estate, on two acres, includes 110 slips and dock space, an 18,000-square-foot building with the marina

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6. DealStats, known as Pratt's Stats for many years, is owned by Business Valuation Resources, https://www.bvresources.com. DealStats includes financials on acquired companies in both the private and public sectors.
showroom, a service bay, and 3,000-square-foot office space on the first floor. The second floor has 10 apartments. The cost approach was used to value the slips, the multiple-use commercial building, and other site improvements. Entrepreneurial incentive was estimated at a relatively high 15%, but the substantial intangible asset value still present is evidence that 15% is supportable for entrepreneurial incentive. The cost approach concludes a value for the land, building, and site improvements of $5,730,000 after depreciation.

The income attributed to the real estate is calculated by the model. The permanent assets are generating income of $634,972, and the charge for the intangibles' income is $134,000 and for the FF&E is $25,842. The real estate income is found via subtraction and is $475,130. The capitalization rate is found by dividing the income by the value, and the resulting overall real estate capitalization rate is 8.29%.

**Real Estate Allocation to Apartments.** The Year 2 monthly market rent for 10 apartments is concluded to be $1,700 per unit per month. Effective rent is concluded to be $187,680 after 8% vacancy. It is difficult to allocate expenses between the three property types since the property is operated as a single business. It is estimated that the apartments’ NOI (or net EBITDAR) margin will be relatively high. A 65% net EBITDAR ratio is estimated, resulting in income to be capitalized of $121,992. Based on multifamily capitalization rates for the local market, and considering the strengths and weaknesses of the subject, a capitalization rate of 5.25% is selected (recognizing that this rate is approximately 25 basis points higher as a Year 2 capitalization rate). Dividing the income of $121,992 by the 5.25% capitalization rate results in an allocated value for the apartments of $2,320,000 (rounded).

**Real Estate Allocation to Office Space.** The 3,000-square-foot office space is analyzed in a similar way as the apartments. Year 2 market rent of $28 per square foot is concluded, with 12% vacancy, resulting in an effective rent of $73,920. A lower NOI margin (or net EBITDAR margin) is forecast compared to the apartments, at 55%. The resulting office space income is $40,656. After reviewing office capitalization rates, a rate of 8.5% was concluded (recognizing this rate is approximately 25 basis points higher than it would be for a Year 1 rate). The concluded office space value is found by capitalizing $40,656 at 8.5%, which is $480,000 (rounded).

**Real Estate Allocation to Marina.** A cost approach was done for the entire property, and allocations within that cost approach were made for the cost of 110 slips and infrastructure, paving, and a 5,000-square-foot retail/warehouse space with showers and toilets. The concluded value was $2,930,000 out of the total real estate value of $5,730,000. Note that the cost approach was not done separately for the apartments and offices, so as not to give too much weight to a single approach.

The marina income is also the residual real estate income, also found via subtraction, and is $312,482. The capitalization rate is calculated as $312,482 divided by $2,930,000, which is 10.66%. Based on previous assignments' marina capitalization rates (generally based on real estate allocations), this is a reasonable real estate capitalization rate for a full-service marina.

**Sales Comparison Indicated**
Marinas are difficult to value via sales comparison because of the different components of individual marinas. Some marinas have only slip rentals. Other marinas also have boat storage, boat dealerships, and service departments. Still others have significant restaurants as a part of the business. In the case example, there is a boat dealership and small service department, plus 10 apartments and 3,000-square-foot office space. A traditional sales comparison analysis dividing the total value by the 110 slips is misleading. The value of the total going concern of $7,400,000 (including inventory) is $67,273 per slip or $59,727 per slip for the total permanent assets. These per-slip values exceed all of the comparable sales. TEEM's indicated per-unit prices solve this problem.

In the model, the apartments’ $2,320,000 value calculates as $232,000 per apartment, while the office space value calculates as $160 per square foot for 3,000 square feet. The marina real estate value calculates as $26,636 per slip for 110 slips (comparables are not available for real-estate-only slip prices). The apartment and office allocations can be supported by local sales of

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those property types. The appraiser might decide to give great weight to these indicated values per unit and make modifications to capitalization rates or income to change the value per apartment or per square foot.

Another way to view the values is to show the indicated per-slip value (and indicated capitalization rates) for the going concern while excluding the apartments and office space. TEEM is presented again in Exhibit 3 showing this analysis. In this model with only marina assets, the per-slip values are more meaningful, with the value per slip at $34,273 for the permanent assets and at $41,818 per slip inclusive of inventory. These are reasonable per-slip values based on sales on file.

### Analysis of Intangible Assets in the Literature

Schmutz’s article, “Valuation of Intangible Property,” does not reference the components of intangibles and simply viewed the intangibles as “residual by nature.”

Mobley in “Defining and Allocating Going-Concern Value Components” references The Dictionary of Real Estate Appraisal, third edition, definition of business value, which included (as a partial list) an assembled workforce, working capital, trade names, franchises, leases, and operating agreements. He allocates value to the identifiable assets and then clearly identifies goodwill as the residual asset, valued by capitalizing excess earnings. The article “Using TEEM-Work to Extend Your Reach” does not cover the different types of intangible assets. Similarly, “Asset Allocations: Are You Reconciling?” only briefly describes types of intangible assets.

Merriman’s article, “Perspectives on the Assembled Workforce,” focuses on the value of the assembled workforce, noting the “Rushmore Approach” does not include this as an intangible asset. That article presents a case study of a prison and concludes an NOI (after allocating to

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FF&E) of $119,527, which is capitalized at 11% to a value of $1,100,000 (rounded). The article’s model then allocates $1,071,458 to the value of the assembled workforce, including $789,495 to the “opportunity cost to the developer,” and $281,963 to the “opportunity cost to capital.” These allocations leave a value of $28,542 (rounded in the computation to $100,000) to be split between other intangible assets and the real estate. The article notes that “not all assembled workforces may warrant a return on investment.”

The article does not conclude that $1,000,000 should be allocated to the assembled workforce, with just $100,000 to all other intangibles and the real estate, although that is what its example appears to suggest. This article suggests that imputing a return on labor and adding an “opportunity cost to capital” results in a double count of the workforce asset. Since “Perspectives on the Assembled Workforce” does not provide a workable alternative to the 91% of value allocation (not including FF&E) to the assembled workforce, it is important to provide one here. The article wisely points out that direct labor cost plus payroll taxes and benefits do not represent all of the costs of maintaining the workforce. Ongoing recruiting, hiring, training, and efficiency losses must also be accounted for, and some employment necessitates other costs such as screening, testing, advertising, and hiring bonuses. The marina case study in the current article estimates these additional costs in calculating the value of the assembled workforce as an asset to be identified within intangible assets. It is not necessarily recommended to go to this granular level of asset allocations for moderate-sized going concern appraisals, but this additional analysis is provided here for discussion purposes.

### Value of the Assembled Workforce

There is no evidence that the value of the workforce involves a return on labor cost as suggested in “Perspectives on the Assembled Workforce.” As previously noted, imputing a return on labor and adding an opportunity cost to capital results in a double count of the workforce asset. The value of the assembled workforce is concluded here to be the marginal cost a business would pay in recruiting, advertising, training, and other costs in assembling the complete workforce. If the total staff had to be replaced over a relatively short

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14. The “opportunity cost of capital” might be more appropriately considered as a “cost to cure” in the event of a loss of staff.
period, the loss in efficiency and other expenses would be a significant percentage of the annual payroll cost. Data on what this percentage should be is not available; lacking market data, we are forced to estimate this cost.

In “Perspectives on the Assembled Workforce,” the opportunity cost to capital was based on 5% of six months’ cost, which is a 16% allocation to the workforce of the total going concern for a labor-intensive prison in that article’s case study. In other situations, such as the marina case study here, the assembled workforce might be allocated 20% to even 40% of the annual payroll cost. Use of 40% of annual cost in the current case study resulted in less than 2% of the total assets of the marina being allocated to the workforce. Economies of scale are indicated here as driving the wide variations in the percentage of payroll cost. Total payroll cost is $230,000 (including payroll taxes) in the marina example, making the workforce value $92,000, rounded to $90,000.

Valuation of Other Intangible Assets. With total intangible assets of $670,000 approximating 10% of total permanent assets, there is no concern that the real estate value is overstated, as there is room for more residual intangible assets after allocating to the assembled workforce. The franchise/dealership agreement with a major boat manufacturer is an important asset but difficult to quantify, as it is presumably mutually beneficial for the franchise to continue. The estimated allocation to franchise income is 5% of boat sales gross profit. With $3,000,000 in boat sales at an 18% margin, gross sales profit is $540,000. Taking 5% of this income ($27,000) and capitalizing at the concluded intangibles rate of 20% results in a franchise value of $135,000. The subject’s business name, brand, and website are considered to be one asset, and this asset is considered to have value similar to the franchise, making its value also $135,000. The “true” residual is the goodwill value. The customer list could potentially be allocated separately but is included here with goodwill. This true residual is found by subtracting the values of the three identified intangible assets (totaling $360,000) from total intangibles of $670,000. The resulting value of goodwill and the customer list is $310,000. So, the residual income of the residual income is the remaining $62,000; dividing this income by $310,000 results in a capitalization rate of 20%. The intangible asset allocations are considered reasonable, though it is acknowledged that another appraisal might have allocated more to the franchise and perhaps less to goodwill.

Conclusions Regarding Asset Allocations

Presence of Intangible Assets
Intangible assets generally have been viewed as the residual value, and assets such as goodwill are residual assets. Yet, the value of the assembled workforce is an intangible asset present in all going concerns (but not failing businesses) that have a complete or near-complete workforce. In the past—when all it took was a help-wanted sign to cure staffing deficiencies—the assembled workforce had negligible value. Now that staffing is costlier to cure, it has more significant value but that does not mean the total value of businesses has increased. Allocating increased value to the assembled workforce in some cases involves subtracting part of the value from other assets (tangible and intangible). Most other intangibles are either directly or indirectly tied to the profitability of the business, and if the value of the going concern falls, virtually all of the intangible assets (excluding the assembled workforce) take a hit.

Businesses can have negative goodwill, an asset similar in some respects to external obsolescence in real estate. If a business has negative goodwill to any significant degree, the business is not likely to pass the threshold of being a going concern, as defined by the accounting profession.

Real Estate Value
The cost approach is often the best way to conclude the real estate allocation, but there are cases where it suggests values that are too low or too high. Increasing the rent in the model is a way to increase the real estate allocation, with net rent capitalized at a market capitalization rate. Market-derived net rent as a percentage of sales or net EBITDAR may result in a significantly higher real estate value than the cost approach. An allocation to real estate based

16. However, the cost approach should be avoided for property types in oversupply, such as golf clubs, as the indicated development cost is likely to be too high (even with zero entrepreneurial incentive), with the deduction for external obsolescence determined by the income approach.
upon the cost approach may be a significantly lower value than an allocation based upon a reasonable rent as a percentage of sales or net EBITDAR. Consequently, sales comparisons should also be checked. With asset allocations, there may be more than one right answer.

**Sellers Determine Asking Prices.** Sellers often determine asking asset allocations, which gives sellers some pricing power, though they must find a buyer willing to pay at or near their asking price. Since real estate capitalization rates are lower than FF&E and intangible asset capitalization rates, and since banks prefer to lend on real estate, sellers who allocate higher portions of the value to real estate will tend to achieve higher sale prices. A cost approach using zero entrepreneurial incentive and one that uses 20% may both be defensible (particularly if the lower real estate value also has a higher intangibles value). If there is still intangible value remaining after assigning entrepreneurial incentive at 20%, there is a good chance the 20% is supportable. If there is no intangible asset value after assigning as little as 5% to entrepreneurial incentive, then the entrepreneurial incentive is probably overstated.

**Going Concern Price Is the Main Price Buyers and Sellers Care About.** Applying as much value as possible to the real estate is logical because banks like to finance real estate and because real estate capitalization rates are lower than other rates. Still, many transactions minimize the real estate value while maximizing intangibles, as sellers want to avoid tax on recaptured past years’ depreciation expenses. There are various motivations that tend to skew asset allocations. But generally, buyers want the lowest total price while sellers want the highest total price, making the going concern price a better test of value than any of the asset allocations.

**Appraisers Must Communicate.** A transaction where a business appraiser appraises the business and a real estate appraiser appraises the real estate can result in a misleading report unless the two appraisers communicate and allocate the income generated by the going concern in a complementary way. If the business and real estate appraisals each conclude $75,000 of income for their assigned assets to be appraised for a business generating $100,000 of net EBITDAR, the result will be a double count of cash flow and overvaluation. For example, consider a convenience store where both appraisers perform a cost approach (called the asset approach by business valuators) and the real estate appraiser considers the underground gas tanks to be attached to the real estate and the business appraiser considers the tanks to be FF&E, resulting in an asset double count via the cost approach. Unfortunately, the US Small Business Administration (SBA) fails to warn or require reconciliation on this issue in its standard operating procedures.17

**Does Strength of Very Profitable Going Concern Impact Value of Real Estate Compared to Weaker, Barely Profitable Going Concern?** It is recognized that many in the appraisal profession consider the value of the fee simple interest to be unaffected by the strength of the going concern occupying the property. This article argues that the appraiser needs to analyze the strength (and creditworthiness) of the going concern in a way similar to analysis of a tenancy in a leased fee appraisal.

It would be difficult to argue against the concept of a property with a credit tenant paying market rent being worth more than a similar property with a similar rent and lease term but a non-credit tenant. This article suggests that the strength of the occupant matters, whether the occupant is a tenant or part of a going concern (with fee simple property rights). The example that follows violates a principle claimed by some appraisers that there can be only one fee simple market value for a property. While good appraisers will disagree with the argument from the next example, we have been unable to find any explicit conflict with the teachings of the Appraisal Institute.

Suppose there are two fee simple appraisals of two restaurants of similar age and size in the same market. One restaurant is a very successful restaurant; it is also a credit tenant, and it buys out the landlord. The lease had ten years remaining at market rent and a 5.5% capitalization rate in a recent appraisal. The average market-extracted capitalization rate for non-credit tenants is 9%. The other restaurant is a recently purchased

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17. At press time, the most recent SBA standard operating procedure is SOP 50 10 6, “SBA Lender and Development Company Loan Programs,” effective October 1, 2020, https://bit.ly/SBA_SOP.
The Total Excess Earnings Model Revisited—It’s Not Just for Going Concerns

-start-up restaurant that is owned by a sole proprietor of average means. When performing the income approach (and utilizing TEEM for the real estate allocations) for these two fee simple appraisals, both are assigned the same market rent. But do both real estate allocations get the 9% average non-credit tenant capitalization rate? Or does the former credit tenant get a 7% real estate capitalization rate because the next day that owner could find a buyer for a sale leaseback at a 5.5% rate? (Not only are credit tenant capitalization rates much lower, but marketability is much greater than for other properties.) The start-up has no ability to refinance or to interest an investor in a sale leaseback. Because of its financial inferiority as a start-up going concern, this property gets a 150-basis-point premium over the average real estate capitalization rate at 10.5%. The 7% and 10.5% capitalization rates for the two properties seem more reasonable than assigning 9% capitalization rates to both simply because both are fee simple appraisals. The strength of the occupant impacts value.

The real estate value is greater when vacancy is low or zero. When a successful going concern (such as a restaurant, car dealership, or funeral home) occupies a property, long-term vacancy is likely to be zero. When a tenant is more likely to vacate—whether during a lease or at the conclusion of a medium-term lease—there are potential costs to the property owner from vacancy, improvements, and commissions. A business that may be forced to move by a landlord at lease end faces moving costs, improvement costs, and business interruption losses, impacting the leasehold value negatively. Weaker going concerns will also have greater vacancy. The low vacancy of a successful going concern can be reflected either in the income allocation to the real estate or in the selected real estate capitalization rate. Either way, the successful going concern is superior to most other properties in this respect.

Typically, little or no value is given to the leasehold improvements since a new occupant will have little use for these user-specific real estate improvements (under the premise of so-called dark store theory). But these improvements are necessary for the going concern to generate its income, and going concerns are valued including all assets necessary for continued operations. A strong and successful going concern is likely to remain at the current location for the long term, and therefore the leasehold improvements (that are attached to the real estate) have value for such going concerns while often not so in medium-term lease situations or in weaker going concerns. Furthermore, the FF&E value is greater if it is not moved. Some FF&E will be damaged when it is moved, and some FF&E is acquired specifically to fit into a specific location. If the business moves, the FF&E is worth something less, making FF&E in a successful owner-occupied property more valuable.

Business value will be greater where there is greater potential for the business to have a long life. If the business moves, the business value will likely be impaired. Logically, a weaker going concern has a higher capitalization rate and less business value as well.

When the business owner also owns the real estate, the going concern brings with it greater flexibility in the management of cash flow and in decision making, such as making a physical change to the real estate to improve functionality for the business. This greater flexibility is attractive to buyers of going concerns, and naturally should be reflected in prices paid.

The above reasons will support a higher value for a successful, owner-occupied going concern compared to a weaker going concern, or a similar leased property with a non-credit tenant (and with the income and value split between landlord and tenant). This article suggests that a strong and successful going concern is similar in some respects to the leased fee property with a credit tenant, as both situations have strong occupants, which entail less vacancy than other leased fee or fee simple occupancies. Such strong going concerns also have the potential for greater growth to the real estate income, with market-derived rent calculated as a percentage of sales or EBITDAR having good potential to increase.

Final Thoughts on TEEM

The example presented in this article shows how to allocate the income of multiple property types that are operated together. The concept here is not new, as it is no different than allocating income to land and to improvements separately (the land residual method), which is often performed.

Some entries into TEEM are difficult to derive. The best way to complete TEEM is to use the best data available to conclude the most reliable asset values, income allocations, and rates. The most difficult entries can become residual numbers that are calculated by the model, adding to its simplicity as well as accuracy.
As shown here, TEEM incorporates high reliance on the cost approach (used for the total real estate and FF&E allocations), while many of the other entries are income based. But as demonstrated in Exhibit 3, “Sales Comparison Indicated” (row 4) is a powerful addition to the model, as it allows weight (potentially substantial weight) to be given to a sales comparison analysis. For example, if reliable market comparables show that the subject’s office space is unlikely to be worth more than $150 per square foot, adjustments can be made to the income or capitalization rate so that the value comes in at or below $150 per square foot. The model becomes a reconciliation of all three approaches to value, adding to its power.

The original excess earnings model was designed over 100 years ago to conclude the value of the intangible assets as a residual. It is best to not make the model calculate other asset values as residuals. Real estate in particular should be valued via at least one approach and possibly as many as three approaches to value. It can be preferable in some cases to use more than one approach for the FF&E valuation. Both the sales comparison and cost approaches might be used. The more the model is used for reconciliation purposes and the less it is used to make actual calculations, the more effective the model is in supporting asset allocations, whether involving multiple property types or components of a going concern, or both, as demonstrated in this article’s example.

It has been argued by some that a value premium for the fee simple interest of successful going concerns is not applicable (compared to the fee simple interest of a weaker going concern or a weaker leased fee interest). Use of TEEM makes it evident that the going concern value for a strong and successful going concern is the highest and best use value, which is synonymous with market value. The real estate that is part of a successful going concern can generally only sell as part of a going concern (or via a sale leaseback involving that going concern). Why close a successful restaurant and sell it for a lower alternative fee simple value? To do so violates the principle of highest and best use.

This article uses TEEM as a model to allocate within the asset class of intangibles. Although this analysis is seldom performed, it has become necessary due to the increasing importance of the assembled workforce as an asset of going concerns. While goodwill and brand value are based on residual value, the assembled workforce is not, making it important to separately estimate its value. There is little available market data to guide appraisers, and it is recognized that we are in the early stages of fully understanding the nature and value of the various types of intangible assets.

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Additional Resources
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American Bar Association
• Business Valuation: A Primer for the Legal Profession

• The Intangible Assets Handbook

• “Young Lawyer Focus: Enterprise Value as Distinct from Equity Value”
  https://bit.ly/3hPpoH1

Appraisal Institute
• Education
  Fundamentals of Separating Real Property, Personal Property, and Intangible Business Assets

• Going Concern Forum, Valuation Issues in Appraising Realty and Non-Realty Components
  http://www.appraisalinstitute.org/assets/1/7/GoingConcern_Presentation_8_17_2011.pdf

• Lum Library, External Resources, Resource Links [Login required]
  Knowledge Base Bibliographies—Business Valuation

• Professional Practice—Value of Going Concern [Login required]

• Publications
  The Appraisal of Real Estate, 15th edition, “Valuation of Real Property with Related Non-Realty Items”

Business Valuation Resources—News & Research
https://www.bvresources.com/products/news-and-research

Small Business Administration—Resource Library
https://www.sba.gov/partners/sbics/resource-library

Willamette Management: Conference Presentations, Webinars, and Professional Journal Articles—
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