

VALUING GOING CONCERNS

AI National Meetings August 2012

Evidence of Intangible Assets

- Benefits of private real estate ownership
 - Unimproved land
 - Raw materials
 - Agriculture
 - Recreation
 - Open space
 - Improved Property
 - Shelter for households
 - Shelter for businesses

Evidence of Intangible Assets

- Real Property Income
 - Royalties (for natural resources)
 - Ground Rent
 - Absolute Net Rent (improved property shelter)

Evidence of Intangible Assets

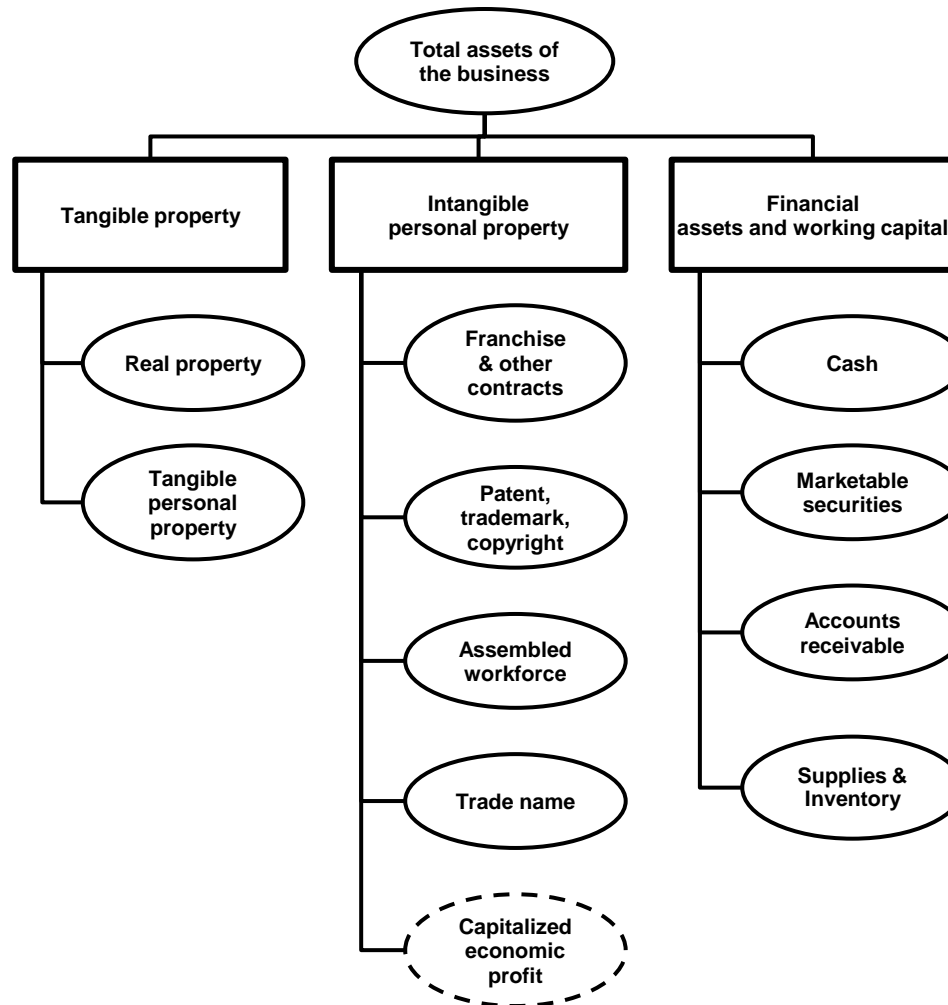
Pure Real Property
(Absolute Net Lease)

USPAP Standards

Standards Rule 1-4(g)

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

Asset Classes



Transaction Types (Businesses)

- Stock based transaction
- Asset based transaction
 - ▣ Identify the asset classes included in the transaction

Competency Rule

Valuation Premises

- **Going Concern Premise:**
The appraiser assumes the business will continue operating indefinitely.
- **Liquidation Premise:**
The appraiser assumes the business ceases operating.
- **Critical part of highest and best use**

Communicating Value Opinions

- Terms that are imprecise, confusing or often used incorrectly:
 - ▣ Business value or business enterprise value
 - ▣ Going concern value
 - ▣ Goodwill
 - ▣ Blue sky
 - ▣ Others

Communicating Value Opinions

- Appraiser must communicate three things:
 - ▣ The type of value being reported (market value, investment value, use value, disposition value, etc.)
 - ▣ The assets or asset classes included in the value opinion
 - ▣ The valuation premise (going concern premise or liquidation premise)

Examples

- *Market value* as a going concern including real property, personal property and intangible property
- *Market value* of the total assets of the business as a going concern, including real property, personal property, intangible property and financial assets

Examples

- *Use value* of the real property only as part of the going concern
- *Market value* of the real property only under the liquidation premise (as if sold vacant and separate from the going concern)

Cost Approach

When the cost approach can be developed reliably, it is very helpful in determining the appropriate allocation of value to tangible asset classes

It may be appropriate to value certain intangible assets by the cost approach (asset approach)

Cost Approach

Issues:

- Proper allocation of each item of cost
- Proper allocation of entrepreneurial incentive
- Recognition of and support for all forms of depreciation

Cost Approach

	Real Property	Personal Property	Intangible Property	Total
Direct & Indirect Cost	\$2,500,000	\$210,000	\$150,000	\$2,860,000
Entrepreneurial Incentive	\$250,000	--	\$100,000	\$350,000
Total Replacement Cost	\$2,750,000	\$210,000	\$250,000	\$3,210,000
Depreciation:				
Physical Deterioration	-\$600,000	-\$42,000	\$0	(\$642,000)
Functional Obsolescence	-\$200,000	\$0	\$0	(\$200,000)
External Obsolescence	\$0	\$0	\$0	\$0
Total Depreciation	-\$800,000	-\$42,000	\$0	(\$842,000)
Depreciated Imps Value	\$1,950,000	\$168,000	\$250,000	\$2,368,000
Land Value	\$600,000	--	--	\$600,000
Value by the Cost Approach	\$2,550,000	\$168,000	\$250,000	\$2,968,000

Sales Comparison Approach

For certain property types, real property rarely sells independently. If some method of allocating sales prices is available, it may be possible to do an allocated sales comparison approach. Otherwise, sales comparison will only provide an unallocated value indication.

Sales Comparison Approach

Possible sources of allocation:

- Actual allocation by buyer & seller
- Interviews of market participants
- Industry standards
- Cost

Income Approach

Capitalization selection criteria

- Method(s) market participants use
- Method(s) with adequate market data
- Adequately refined method to solve the problem

Income Approach

Overall capitalization without allocation
to asset classes

Sale Price (real property, personal property and intangible property): \$2,900,000

	Income	Rate/Factor	Type
Gross Revenue	\$880,000	3.30	Revenue Multiplier
Cost of Goods Sold	-\$130,000		
Gross Profit	\$750,000	3.87	Gross Profit Mult
Payroll (excluding owner)	-\$180,000		
Franchise Fees	-\$35,000		
Other Operating Expenses	-\$110,000		
Property Tax & Insurance	-\$40,000		
SDE (seller's discretionary earnings)	\$385,000	7.53	SDE Multiplier
Market Payroll for Seller's Labor	-\$30,000		
EBITDA/EBITDARM	\$355,000	8.17	EBITDA Multiplier
Management Fee	-\$44,000		
Replacement Reserves (including F&E)	-\$21,000		
Net Operating Income	\$290,000	0.10	Overall Cap Rate

Income Approach

Overall capitalization with allocation to asset classes

- Excess earnings method
- Real property as a residual

Excess Earnings Method

	Without Mgmt Fee	With Mgmt Fee
Gross Revenue	\$880,000	\$880,000
Cost of Goods Sold	-\$130,000	-\$130,000
Gross Profit	\$750,000	\$750,000
Payroll	-\$210,000	-\$210,000
Franchise Fees	-\$35,000	-\$35,000
Other Operating Expenses	-\$110,000	-\$110,000
Property Tax & Insurance	-\$40,000	-\$40,000
EBITDAR/EBITDARM	\$355,000	\$355,000
Management Fee	--	-\$44,000
Real Property Rent	-\$230,000	-\$230,000
Return on/of Personal Property	-\$31,778	-\$31,778
EBITDA (Intangibles Income)	\$93,222	\$49,222

Excess Earnings Method – Capitalization

Example without Deduction for Management Fee

	Income	Cap Rate	Value
Real Property	\$230,000	0.0950	\$2,421,000
Personal Property	\$31,778	0.1892	\$168,000
Intangible Property	\$93,222	0.3000	\$311,000
Total as a Going Concern	\$355,000	0.1224	\$2,900,000

Example with Deduction for Management Fee

	Income	Cap Rate	Value
Real Property	\$230,000	0.0950	\$2,421,000
Personal Property	\$31,778	0.1892	\$168,000
Intangible Property	\$49,222	0.1583	\$311,000
Total as a Going Concern	\$311,000	0.1072	\$2,900,000

Estimating Real Property Rent

- Rent comps (ideal)
- Sale-leaseback transactions
- Build-to-suit leases
- Rents for physically similar real property
- Rent-to-revenue ratio (from industry benchmarking study, interviews of market participants, etc.)
- Lease constant applied to depreciated cost

Estimating Real Property Cap Rate

- Leased fee sale comps (ideal)
- Cap rates for other property types with similar risk characteristics and income/value pattern
- Built-up rate (i.e. band-of-investment, property models, etc.)

Estimating Personal Property Rent

- Depreciated cost of personal property times amortization factor for remaining economic life
- Return of investment (straight-line replacement reserve) plus return on investment (depreciated cost times discount rate)

Estimating Intangible Personal Cap Rate

- Individual intangibles sale comparables
- Discussions with business brokers
- Pratt Stats or other database

	Without Deduction for Income to Financial Assets	With Deduction for Income to Financial Assets
Gross Revenue	\$880,000	\$880,000
Cost of Goods Sold	-\$130,000	-\$130,000
Gross Profit	\$750,000	\$750,000
Payroll	-\$210,000	-\$210,000
Franchise Fees	-\$35,000	-\$35,000
Other Operating Expenses	-\$110,000	-\$110,000
Property Tax & Insurance	-\$40,000	-\$40,000
EBITDAR/EBITDARM	\$355,000	\$355,000
Management Fee	-\$44,000	-\$44,000
Income to Personal Property (\$168,000 x 0.1892)	-\$31,778	-\$31,778
Income to Intangible Property	-\$49,222	-\$49,222
Income to Financial Assets (\$90,000 x 0.04)	--	-\$3,600
Residual Income (Rent) to Real Property	\$230,000	\$226,400
Real Property Capitalization Rate	0.0950	0.0935
Real Property Value	\$241,000	\$241,000