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When Do You Need to Involve a Business Appraiser?

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Presentation Outline

- BV, RP & M&E Appraisers See Things Differently
- Standards of Value and Premises of Value Issues
- Special Purpose and Weird/Unusual Properties
- Complex Real Property Going Concerns
- Working with a Business Appraiser
- Some Example Properties with Wrinkles
- Questions from the Audience
- Business Appraiser Training

BV, RP & M&E Appraisers See Things Differently

- Business Appraisers
  - Most Often Value Equity
  - Commonly Value Less than 100% Interests
  - Most Concerned with Cash Flow (an After-Tax Income Stream)
  - Commonly Analyze Financial Statements and Income Tax Returns
  - Struggle to find Market Data Very Similar to the Subject
  - Appraisal Methodology Typically More Complex and Disputes Between Appraisers Common
  - Cost to Reproduce Data (Asset Approach) Scarce or May Require RP and/or M&E Appraisals
  - Selection of a Capitalization/Discount Rate Very Subjective

- Real Estate Appraisers
  - Almost Always Provide an ASSET Value, not EQUITY
  - Rarely Value Less Than 100% Interest
  - Most Concerned with Net Operating Income (a Pre-Tax Income Stream)
  - Simplistic Financial Analysis and may be unfamiliar with Complex Tax Returns
  - Generally Have Market Data Very Similar to the Subject
  - Appraisal Methodology Typically Specified and Well Defined
  - Have Very Good Cost to Reproduce (Cost or Asset Approach) Data (i.e. Marshall & Swift and Others)
  - Often Can Extract a Capitalization Rate from the Market or Have Other Data to Provide Support

- Machinery & Equipment Appraisers
  - Almost Always Provide an ASSET Value, Not EQUITY
  - Rarely Value Less Than 100% Interest
  - Rarely Use an Income Approach (when attempted, usually very simplistic and not well supported)
  - Most Often Rely on Sales Comparison Approach – Generally Have Lots of Data
  - Occasionally Use a Cost Approach – Have Some Data to Support

Standard and Premise of Value

- Business Appraisers
  - Most Commonly Use "Fair Market Value"
  - Occasionally Use "Fair Value" or Some Other Defined "Value"
  - Premise of Value is Generally "Going Concern" – Can be Liquidation
- Real Estate Appraisers
  - Most Commonly Use "Market Value"
  - Occasionally Use "Value in Use" or "Value of a Going Concern." However, Most RP Appraisers are NOT familiar with How to Do These Types of Assignments
  - Premise of Value can be "As Is", "As Completed", "At Stabilization", "As Gone Dark", or "Value in Use"

- Machinery & Equipment Appraisers
  - Quite a Few Standards of Value are Used:
    - Fair Market Value
      - Fair Market Value – Removed
      - Fair Market Value in Continued Use with Assumed Earnings
      - Fair Market Value in Continued Use with an Earnings Analysis (Not Commonly Done, or If Done, Rarely Done Well)
      - Fair Market Value – Installed
    - Liquidation
      - Orderly Liquidation Value
      - Forced Liquidation Value
      - Liquidation Value in Place
    - Other – There are a “Host” of Other Definitions, Usually Supplied by the Client
  - Premise of Value Can Be “Removal for a Similar Use”, “Removal for an Alternate Use” or “Value in Place”

- Special Purpose Properties (Weird/Unusual Properties)

There are some serious problems and major disagreements between appraisers and users of appraisals associated with the appraisal of many **special purpose properties** (a property with a unique physical design, special construction materials, or a layout that particularly adapts its utility to the use for which it was built) and **real property going concerns** (a type of real property that derives its income stream from the operations of a business rather than from the collection of rent).

The BIG problem that often occurs is associated with the determination of just what is the market value of the real property in these cases.

Critical to Understand and Agree – Proper Standard of Value and Premise of Value to be used in the Appraisal(s)

- Example

Used with Permission from Kerry Jorgensen, MAI – Article "Market Value in Use is Not an Oxymoron" published May 15, 2018 in Real Estate Issues, Volume 42, Number 7

Problem: Recently constructed Porsche auto dealership – cost to develop of $4,000,000 including land, building, and appropriate developer profit. However, included in the construction are many brand specific specialties resulting in another brand dealership being unwilling to pay more than $3,200,000 for the real property.

Question: What is the “Market Value” of the Property?

Answer: It Depends…..

- Would it be valued at $4,000,000 or $3,200,000 for a lender to make a permanent loan?
- What is the value for property taxes -- $4,000,000 cost or $3,200,000 price it could be sold for to another dealer?
- If the business, including the real property were sold, what value should be allocated to the real property?

- KEY – Purpose and Use of the Appraisal - Understanding and properly applying the concept of **Value in Use** vs. **Value in Exchange** when applicable

Value in Use is defined as "The value the real estate contributes to the enterprise of which it is a part." [This is really a Premise of Value]

Value in Exchange is defined as "The value of a property on a stand-alone basis, separate and apart from other assets or the enterprise of which it is a part."

- Kerry Jorgensen, MAI suggests the addition of the following two definitions for real estate appraiser:

1. Market Value in Use – market value under the value in use premise; assumes the property is sold in combination with other assets as a group.
2. Market Value in Exchange – market value under the value in exchange premise; assumes the property is sold separate and apart from any other asset.

My Suggestion – use Market Value in Use when needed, i.e. when valuing real property as part of an enterprise so that the BV appraiser gets the Value Allocation correct.

- Market Value in Use – KEY POINTS
  - Market Value in Use Cannot exceed replacement cost new minus physical depreciation because the value contribution cannot exceed what a buyer of the enterprise would expect to pay for a replacement
  - If the property is vacant or not used for the purpose for which it was originally designed, it is unlikely that the current market value in use exceeds market value in exchange
  - Some Complex Properties, i.e. a large food processing facility built specifically for a specific company, will likely require the combined efforts of a RP, M&E, and a RP appraiser

Complex Single-Purpose Facilities

- Without the continued profitable operation of the business, the real property would very likely not be of use or interest to another user/buyer without substantial modifications.
- The problem in valuing the real property alone is the determination of what is being valued and for what purpose. If valuing the real property to assist in a purchase price allocation when the entire enterprise is being acquired by another company, the standard of value should likely be "Market Value in Continued Use."
- If the purpose of the appraisal is for a real estate property tax assessment appeal, what is the appropriate standard of value and premise of value that should be used? Should it be Market Value? If so, should it be valued using sales of closed food processing facilities available for sale with the need for substantial remodeling to meet the next user's specific needs? Should it be valued using the cost approach, i.e. the replacement cost new less an allowance for depreciation? If so, should the depreciation include functional obsolescence and/or external obsolescence and how should these amounts be determined?

These types of problems are case specific – the answers are complex and varied and equally competent appraisers may disagree and derive value conclusions that widely differ yet, both may be supportable depending on the assumptions made and used.

Complex RP Going Concerns (Require BOTH a RP & BV Appraiser – maybe an M&E)

- Amusement Park
- Large Assisted Living Facility
- Convention Center
- Hotels with Restaurant
- Large Nursing Facility
- Specialized Manufacturing Facility (i.e. Food Processing)
- Truck Stop
- And Many Other Properties with Integrated RP and Businesses

Working with a Business Appraiser

- You MUST be on the Same Page – not as easy as it sounds. Agree on Standard of Value and Premise of Value to be used, i.e. does the business appraiser need the RP value and market lease rate for a property "in use" or "as dark" or ….?
- Business appraisals often have a specific required effective date – it is rarely the date the property/business is viewed.
- Remember, most of the time the business appraiser is valuing EQUITY, not the assets that would normally transfer in a sale.
- Good idea to develop a relationship with a good BV appraiser so that you can get help with any BV issues that arise in your practice – BV appraisers often need help with market rent.

Business Appraisal Approaches & Methods

- Asset (“Cost”) Approach
  - Adjusted Book Value Method
  - Liquidation Method
- Market (“Sales Comparison”) Approach
  - Guideline Public Company Method
  - Transaction Method
    - IBM Market Data Transaction Method
    - BizComps Data Transaction Method
    - Peer Comps Data Transaction Method
    - Deal Stats (formerly Pratt’s Stats) Data Transaction Method

Business Appraisal Approaches & Method (Continued)

- Income Approach
  - Capitalization or DCF Using Net Cash Flow to Equity (Build-up Method)
  - Capitalization or DCF using Net Cash Flow to Invested Capital (WACC)
  - Capitalization using Schilt’s Table
  - Excess Earnings Method (combo Asset & Income)
  - Multiple of Discretionary Earnings Method

Business Appraisal “Wrinkles and Other Issues”

- Too Numerous to Cover them All – Here are some common problems to watch for
  - Build-up Discount or Capitalization Rate – no or very little support for the Specific Company Risk Premium

    Risk Free Rate

    Equity Risk Premium

    Small Company Risk Premium

    Specific Company Risk Premium
  - Improper Development of Net Cash Flow – after tax income stream, add depreciation, amortization & depletion, less capital expenditures, adjust for changes in working capital and long-term debt

Business Appraisal "Wrinkles and Other Issues" (Continued)

- Use of Net Cash Flow to Invested Capital when a personal guarantee or pledge of assets is required
- Insufficient financial analysis of the Company
- Hockey Stick Income Forecasts i.e. plant is at capacity and 30% revenue is forecasted for next year
- Failure to anticipate future competition and major changes in the industry
- And many, many more ….

Business Entities with Real Property - "Simple" Real Property Going Concerns

Assisted Living Facility

- Management intensive business – requires extensive knowledge of Medicaid rules and other regulations
- Comparison to Industry Average ratios and expenses – current industry status and data critical
- Sales Comparison Approach very difficult to apply – hard to adjust for differences (sanity check)
- Cost Approach – can be used to support real estate "as dark" value for market lease estimation
- Income Approach – difficult to support appropriate cap rate; operating business tied to real property

Auto Dealership

- Single-Purpose building(s)
- Knowledge of auto industry/industry data critical
- Certain dealer franchises more valuable than others
- Sales Comparison Approach difficult – hard to adjust for differences between locations and business operations
- Profit Centers are: Parts, Used Cars, Finance & Insurance (F&I), and Service. New car sales typically have very low margins.
- CRITICAL: What standard of value/premise of value is applicable?

Bowling Center

- Special-Purpose building; expensive to build
- Location, age of equipment, physical condition of facility and other amenities are important, i.e. food service, size of arcade, and other activities such as laser tag, go carts, etc.
- Superior customer service and personal attention is critical to long-term success. Setting up and maintaining bowling leagues generates ongoing revenue
- Requires good management and serious promotion / advertising for continued success
- Sales Comparison Approach difficult to apply – Price per Lane used in industry

Coin Operated Self-Serve Car Wash

- Traffic pattern, traffic county, visibility and access directly affects revenue – Capture Rate (typical 0.45% – meaning if 20,000 average daily traffic count, 90 cars per day)
- Condition and appearance important
- Largely a cash business – skimming by owners common; typically can only use "reported" income; exceptions for divorce or some other purposes
- Comparison to industry data for expenses important, can "back into" likely revenue if needed
- Sales of "business only", i.e. rental of real property are rare

Full Service Car Wash

- More complicated than coin operated self-serve units as there are several profit centers with different profit margins
- Similar location and capture rate issues to coin operated self-serve units
- Business portion value requires good financial statements / tax returns which may or may not exist
- Comparison to industry data important

Fast Food Restaurant (Owns Real Property)

- Need to determine “market rental rate” for real property “as if” leased from an independent third party, insert rental expense into income statements and value the business portion
- Franchise units often sell for more than “mom and pop”
- Effective management critical to success – focus on food costs and payroll costs compared to industry data
- Business appraiser market data very helpful in valuing the business portion
- Age and condition of equipment and seating package as well as general appearance of building is important

Gas Station/Convenience Store

- Location and competition (including possible future competition) – also future known traffic pattern changes are critical
- Additional revenue sources such as franchise restaurants, tobacco sales, drink and other snack sales, ATM machines, game machines, fresh fruits, deli items, etc. are important
- Important to get sales revenue and cost of sales broken out by revenue source – petroleum sales have a very low margin
- Compare margins on sales categories to prior years and to industry data for trends
- Environmental issues must be considered – insurance coverage

Golf Courses

- Golf courses are challenging to value
- Most are built in conjunction with a subdivision in order to sell high-end homes
- Typically a low profit operation
- Majority of value is in the real property – useful sales comps for golf courses are often very difficult to find
- KEY – purpose and use of the appraisal; i.e. is the course to be closed and redeveloped? If appraisal is for a refinance, membership revenue may be critical – membership increasing or decreasing?
- Competition in area – more courses have been closing each year than new ones added lately
- Check industry – lately, more golfers leaving sport than entering

Hotels & Motels

- Considerable data and guidance for real estate appraisers available
- Financial analysis of subject to itself over time and to the industry data is important – management has a big impact
- Hotels often change their “flag” (franchise affiliation) – when a change occurs, a PIP (Property Improvement Plan) is typically required
- Critical data: ADR (Average Daily Rate), Occupancy Rates & RevPAR (Revenue per Available Room) – Source: STAR Report

Mini-Storage (Self-Storage) Facility

- Comparison of historical income and expenses critical
- Competition in the area – new units expected?
- Key Factors: Vacancy and turnover of units. Rental comparison to competition
- Management and staff – often have a live-in management person or couple; may be hard to replace if they leave
- Great way to hold land for future change in highest and best use – must be considered

Mobile Home Parks

- Comparison of historical financial statements over time is critical
- Age and condition of underground utilities directly impacts the value – costly to replace
- Number of units in park that are rented vs. owned AND number of units in park owned by park is important
- Manufactured Homes in park OR older, mobile homes?
- Difficult to get approvals to build new mobile home parks
- History of space rent increases

Movie Theaters

- These can be difficult – single-purpose building
- Age and condition of building is important – multiple screen facilities are the “norm”
- Concession sales drive profits
- Revenue is dependent on number of “blockbuster” films in a year – may vary considerably
- Periodic upgrades of seating and other amenities is required

Nursing Home

- This is a specialty – requires good industry data and critical factors change over time and are often tied to changes in Medicaid and Medicare.
- Mix of Government payors and private payors is critical due to limitations on Medicaid payments
- Management is also critical – comparison of facility income and expenses to itself and to industry data is required
- Sales Comparison Data often gives a wide range of price per bed – buyers and sellers base decisions on cash flow; capital expenditures must be taken into consideration

Questions?

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