Ideally, the capitalization rate applied to real property income would be extracted from comparable sales of real property only. However, for some property types, real property rarely sells independently from personal property and intangible property, so direct capitalization comparables are scarce. In those cases, it may be possible to extract rates from sales of going concerns using a residual method. Another consideration is the use of capitalization rates for other property types that have similar income pattern and risk characteristics. If adequate support is available, it may also be possible to calculate a real estate capitalization rate using a band-of-investment technique or a property model formula. When data is scarce, use of more than one method of determining the capitalization rate can strengthen the analysis.

The capitalization rate for the intangible property should also be based on comparable data, to the extent possible. As with real property, it may be possible to use a residual technique to extract rates from comparable sales of going concerns when sales of intangibles only are not available. For many types of businesses, comparable data is available from vendors who compile that data specifically for use by appraisers, brokers, and others. It is also helpful and important to interview business brokers and other market participants.

Parsing Income Method

In cases where the assignment is to value real property only, some appraisers use the parsing income method, which is a variant of the excess earnings method of business valuation. The difference in the parsing income method is that real property, personal property, and intangible business income and expenses are allocated at the same time. An appraiser should be cognizant that the tangible items have priority, and specifically that of the real property is the first priority. Table 37.5 illustrates two common formats. The intangible assets must be identified, and an income allocation assigned to each. The income

Table 37.5 The Parsing Income Method

	Without Deduction for Financial Assets	With Deduction for Financial Assets
Gross Revenue	**$880,000**	**$880,000**
Cost of Goods Sold	– $130,000	– $130,000
Gross Profit	**$750,000**	**$750,000**
Expenses:		
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*	– $45,622†
Income to Financial Assets ($90,000 x 0.04)	n/a	– $3,600
Residual Income (Rent) to Real Property	**$230,000**	**$230,000**
Real Property Capitalization Rate	0.0950	0.0950
Real Property Value Indication (rounded)	**$2,421,000**	**$2,421,000**

* In Table 37.3, the $49,222 income to the intangible property was derived as the residual income remaining after deducting the income to the real estate and the personal property.

† Because the intangible property gets the last allocation of income, allocating part of the income to the financial assets necessarily results in a reduced allocation to the intangible property.

allocation is based on either (a) estimating the amount the intangible asset contributes to income or reduces expense or (b) estimating the value of the intangible asset by some other method and multiplying by an appropriate capitalization rate. In some models, deductions are also made for returns to financial assets. Again, consistency in extraction from market data and application to the subject property is key. Consistency must be maintained both in how income is calculated for the numerator in the capitalization rate calculation and in what assets are included in the denominator for the calculation. The valuation of a going concern that is centered on a real estate component may not include financial assets. Often, financial assets may not be included in the transfer of these properties. Table 37.5 illustrates the analysis with and without financial assets included.

In real estate appraisals, it is accepted that land has a priority claim on the value of improved real property. The total value of improved real property is allocated first to the land at its highest and best use, and the improvements are allocated the remainder. In a similar way, real property appraisers generally view the tangible assets as having a priority claim on the value of the going concern. Therefore, when treating real property as a residual, some of the same caution is necessary as would be true for a land residual technique in a real estate appraisal. The appraiser must use care that, in allocating income to the intangible property, the allocation is limited to the amount the intangible assets actually contribute to the income of the entire going concern. Profit is the reward received for the successful completion of a venture. In economic theory, the residual share of the product of enterprise accrues to the entrepreneur after all payments for capital (interest), for land (rent), and for labor including management (wages). Profit is therefore the earnings that an entrepreneur receives after all other agents of production have been paid.

The parsing income method is consistent with the going-concern premise. The application of the method starts with an allocation of income and expenses to each of the asset classes, which is known as "contributory asset charges" in the business valuation community. Once the net income to each asset class is identified, it can then be capitalized into an indication of value by dividing by an appropriate capitalization rate or multiplying by an appropriate factor for each asset class. Alternatively, as shown in Figure 37.5, when only the value of the real estate is being sought, then capitalizing the income net of the contributory asset charges will accomplish this objective.

In the use of the parsing income method, it is critical for appraisers to ensure that any allocation of the income and expenses correctly identifies the contribution of the income to the total assets from tangible and intangible personalty. If the allocation is not done properly, it is unlikely that the residual value for any asset class will be correct. Critics state that this methodology is flawed because the identification of an appropriate capitalization rate to convert the residual income to different asset classes can be difficult. This method has also been criticized for the deductions applied for a return on the various components of the going concern, which create an opportunity for double-counting unless caution is exercised by an appraiser.

The Management Fee Approach

The management fee approach has been used by some appraisers as a variant of overall capitalization analysis. From that viewpoint, deduction of franchise fees and management fees accounts for returns to the business, and replacement reserves account for future replacement of furniture, fixtures, and equipment. This approach of valuing tangible assets exclusive of intangible assets is based on the theory that once the revenue attributable to intangible assets is deducted, all other remaining income is attributable to the real property and other tangible assets. In other words, this approach involves the calculation of a residual, in much the same way that residuals are calculated in land residual analysis or in the various residual calculations in the income capitalization approach. The management fee approach is similar to the business valuation approach called *relief of royalty*, where the value of the intangible property is equal to the value of the royalty payments from which the company is relieved by virtue of its ownership of the asset. Critics of this method assert that the value of intangible assets and rights cannot be removed by merely deducting the related expenses from the income stream to be capitalized; allowing a deduction for the associated expense does not allow for a return on the capital expenditure. However, proponents of this approach counter that a return on capital is implicit in the management fee or relief of royalty. These management fees enable the provider to operate a profitable business and obtain a return on and return of capital.

For a hotel property, proponents of this approach would deduct the management fee and franchise fee (if it is a branded hotel affiliated with a chain) along with other operating expenses. By removing management fees and franchise fees from the revenue, appraisers reason that the influence of intangible assets has been eliminated. This approach maintains that the offices, staff, salaries, and overhead associated with management of the hotel reside not with the owner of the real property but with the company that manages and operates the hotel for the owner of the real property. Advocates of this approach state that because the management fee compensates the management company for those expenses, including staffing the hotel, the value of any intangible assets is removed, and any remaining net income is attributable to the real property. Advocates further state that, in the case of branded hotels, removal of the franchise fee eliminates intangible assets attributable to the brand and the final result represents only the value of the real property and the tangible personal property.

The management fee method is also sometimes used by appraisers to account for intangible assets inherent in other property types that typically have a business management fee or franchise. Proponents of this approach say it is justified on the same grounds as the market participant survey-based approach described below in situations where market participants rely solely on the deduction of management fees to account for intangible assets. A different view is that removal of the cost of an asset or service does not remove all value associated with the existence of that asset or service. For example, opponents of this method suggest that paying the utility bills on a property does not remove the value associated with having the property served by electricity, gas, water, and sewer service.

Market Participant Survey Approach

Interviews with market participants and, in some cases, regulatory filings may be used to assist in understanding the value allocated to intangible assets in market transactions. For example, in valuing specific property types, appraisers may interview market participants to ascertain how buyers and sellers of those properties value or allocate intangible assets in pricing decisions. The same questions may also be posed regarding personal property and how this property is valued or priced. The objective of that sort of exercise is to determine the thinking of market participants on these issues as opposed to relying on post-transaction book values recorded by accountants in financial statements.

Appraisers also research filings with the Securities and Exchange Commission. Given the dominance of real estate investment trusts (REITs) in various property classes and the regulatory requirements imposed on publicly traded companies, these filings may be insightful, if only as a secondary source. According to Accounting Standards Codification Topic 805: Business Combinations, companies are required to allocate the purchase price of an acquired company among the tangible and intangible assets when acquired. As discussed in Chapter 36, the 2017 update to ASC Topic 805 redefined a "business" to clarify the conditions under which a transaction involves a business combination or an asset acquisition, which are treated differently on balance sheets under generally accepted accounting principles (GAAP).

Sales verifications and market interviews may be used as the foundation for the treatment of intangible assets. Advocates say that the strength of this approach is that its conclusions are tied directly to the marketplace. It also recognizes the possibility that treatment of intangible assets may vary based on property type (e.g., convenience stores, marinas, stadiums, and health care properties) and asset class. Critics of this approach say that survey responses of buyers and sellers may be influenced by tax or financial considerations or other nonmarket conditions, which may result in a skewed survey. Critics also assert that buyers and sellers may have no need or motivation to allocate the value of traded assets to the various component parts and that this is not really a method at all but only a part of normal verification requirements of professional standards for comparable data.

Reconciliation

As with all appraisals, in the reconciliation of the approaches to value, appraisers consider the relative strengths and weaknesses of each of the approaches and arrive at a final value opinion. Depending on the scope of work, the value opinion for a property operated as a going concern may require an allocation of the value opinion between the asset classes. Table 37.6 illustrates how an appraiser might compile the results of the valuation techniques applied to assist in reconciling those value indications.

In some assignments, the scope of work may include an allocation of value to the asset classes, but it may not be possible to make the allocation within the approaches to value. In those cases, it may be appropriate to first reconcile to a final value opinion for the property overall and then estimate the appropriate allocation as part of the reconciliation process. Two methods commonly used to allocate the value opinion within the reconciliation are the cost approach and market participant surveys.

Table 37.6 Reconciliation

	Real Property	Personal Property	Subtotal Tangible Assets	Intangible Property	Total Value as a Going Concern
Cost approach	$2,550,000	$168,000	$2,718,000	–	–
Sales comparison approach	–	–	–	–	$2,950,000
Income capitalization approach	$2,421,000	$168,000	$2,589,000	$311,000	$2,900,000
Final value opinion	**$2,420,000**	**$170,000**	**$2,590,000**	**$310,000**	**$2,900,000**

Note: In this example, the cost approach is used only to value the tangible assets. The income capitalization approach uses the excess earnings method and therefore provides a value indication for each of the asset classes. The sales comparison approach is used only to value the total property as a going concern, without allocation. The breakdown of the approaches will vary depending on the assignment and on the information available. For example, it may be possible in some assignments to derive a value indication for intangible assets by the cost approach. In other assignments, the income capitalization approach may only provide a value indication for the property as a going concern, without allocation.