



Valuing Real Property Going Concerns

By Paul R. Hyde, EA, MCBA, ASA, MAI

The Problem

Most everyone agrees that valuing real property falls under the purview of real estate appraisers and requires a real estate appraisal license in the jurisdiction in which the property is located. Many people agree that valuing a business entity (often referred to as a going concern) requires special skill and expertise possessed by qualified business appraisers. The problem occurs when the need arises to value a business enterprise that is difficult to distinguish from real property. The majority of licensed real estate appraisers do not have the education, training, and experience to value a business and business appraisers do not have the license, education, training, and experience to value the real estate component.

The purpose of this article is to outline and clarify the problem, as I see it, and to propose solutions as to how various real property going concerns should be valued ... and by whom. Some real property going concerns can relatively easily and competently be appraised by real estate appraisers; others require both a real estate and a business appraiser. I will explain and clarify which real property going concerns fall into each category which should assist appraisers, and those that order appraisals, to determine who should be retained to appraiser various real property going concern types.

My Background & Qualifications

Why should you read and pay attention to this article? I am a business and real estate appraiser. I specialize in appraising business and real estate combinations and have written and taught many appraisal classes over the years. I am an Enrolled Agent (Enrolled to Practice Before the IRS), a Master Certified Business Appraiser, an Accredited Senior Appraiser in both Business Valuation and in Real Property – All Types, and an MAI real estate appraiser. I am also a Senior Appraiser with the American Society of Agricultural Appraisers – a machinery, livestock, and equipment appraiser. My work experience includes being a commercial loan officer, the Chief Financial Officer for a 46-unit restaurant chain, real estate development and construction, commercial real estate and business brokerage, and for the last fifteen plus year's full-time real estate and business appraisals.



Terminology

Another part of the problem associated with valuing real property going concerns is the wide dispersion of different terminology and the lack of agreement among those trying to describe the entities in question. Many real estate appraisers refer to what I call a real property going concern as simply a “going concern.” The problem with this definition is that many businesses without a real estate component (except perhaps for office or industrial leased space) are referred to by many as a going concern. In business valuation, businesses are typically valued under one of two basic premises: a going concern scenario or a liquidation scenario.

L. Deane Wilson, MA, ASA and Robin G. Wilson, MAI in their text, *Going Concern Valuation for Real Estate Appraisers, Lenders, Assessors, and Eminent Domain*ⁱ, do an excellent job explaining many of the problems associated with these types of valuation, but their definition of “Going Concern” could include business entities without real property.

David C. Lennhoff, MAI, SRA, Maureen Astroieni, MAI, and James D. Vernor, MAI, Ph.D. in their class materials for *Fundamentals of Separating Real Property, Personal Property, and Intangible Business Assets*ⁱⁱ, refer to the concept in question as the “Market Value of the Total Assets of the Business.” This term is not widely used and is not used by business appraisers.

Ben Wilcox, CBA, MAI in his article *Complexities in the Use of Real Estate Appraisals*ⁱⁱⁱ uses the term “Interdependent Properties” meaning “one in which the revenue and the income of real estate and the business that occupies it are intertwined and difficult to separate.” This definition is a good one, however, I believe that the term Real Property Going Concern is more clear and concise.

Defining the Appraisal Subject

Clearly, a significant part of the problem when valuing real property going concerns is to clearly define what is being appraised so that no misunderstanding can be reached regarding what the value conclusion presented in the appraisal includes.

Most often, real estate appraisers are asked to conclude to the market value of a specific real property defined by a legal description. This typically means the value at which the property would likely sell with a specified marketing period and exposure time using a “standard” definition of market value. This value conclusion represents the total value of the property, i.e. not the equity in it and it does not include the value of business type assets such as cash, accounts receivable, inventory, etc. that may or may not be present as of the effective date of the appraisal.



Business appraisers are often asked to conclude to the fair market value of the equity in a business enterprise (i.e. net of long-term debt) rather than the value that the assemblage of assets would sell for using a definition of fair market value such as that set forth by IRS Revenue Ruling 59-60 or the very similar definition set forth in the International Glossary of Business Valuation Terms, adopted by all of the major business appraisal organizations.

The key points outlined in these definitions are both the buyer and seller must be willing without any compulsion to buy and sell, they must each have a good understanding of all relevant facts regarding both the company and the market for it, they must be able to make such a trade, and the value is expressed in terms of cash equivalents.

The concept of Premise of Value is defined by the International Glossary of Business Valuation Terms as: “an assumption regarding the most likely set of transactional circumstances that may be applicable to the subject valuation; e.g., going concern, liquidation.”^{iv}

When valuing a Real Property Going Concern it is critical to define just what is included and the standard of value used. This will usually depend on the purpose and use of the appraisal. If the appraisal is being done for a lender, particularly a lender associated with the Small Business Administration, the value sought is typically the value of “the assets that would typically transfer in a sale” rather than the equity in the entity. If the value is needed for a divorce, for estate and gift work, or for some dispute, it is often the fair market value of the equity in the entity. The value conclusion reached must be clearly defined so that it is impossible to misunderstand.

Going Concern Property Types

I divide going concern property types into two categories: Simple Real Property Going Concerns and Complex Real Property Going Concerns. Of course, there is a grey line separating these two categories as some real property going concern types could fall into either category depending on the facts and circumstances.

Simple real property going concerns can be relatively easily appraised by real estate appraisers using typical real estate appraisal approaches and methods. Complex real property going concerns require both a real estate appraiser and a business appraiser.

Simple Real Property Going Concerns

Simple real property going concerns are those that can usually be appraised using an improved property sales comparison approach with minimal differences between the Subject and the sales comparable data available. In other words, those assignments that do not require an identification of the amount, if any, of intangible asset value present. Instead, all that is required is the total value of the real property going concern.



Simple real property going concerns include, but are not limited to, the following property types:

- Assisted Living Facilities
- Auto Dealership
- Auto Repair or Tire Center
- Bowling Center
- Coin Operated Self-Serve Car wash
- Fast Food Restaurants
- Full Service Car Wash
- Full-Service Restaurants
- Gas Station – Convenience Store
- Golf Courses
- Hotels
- Mini Storage Facilities
- Mobile Home Parks
- Motels
- Movie Theaters
- Nursing Homes
- Recreational Vehicle Parks

Real estate appraisers have sufficient data and expertise to determine the value of the real property, and often the combined real property and intangible business value, of simple real property going concerns. Real estate appraisers can often find sales of these types of properties that include the business operations as well as sales of vacant real property. They also often attempt an income approach using a capitalization rate extracted from the market to identify the combined real property and intangible asset value of the real property going concern.

It should specifically be noted that real estate appraisers are not qualified or competent to determine the amount of intangible assets, if any, for any of these simple real property going concerns. Should the assignment require identification of the intangible asset value, a competent business appraiser should also be included in the assignment and the real estate appraiser should determine the market value of the real property only. The methodology and data available to real estate appraisers is insufficient to determine the business value portion of any real property going concern. The real property and intangible asset components of a real property going concern have very different risks and the appropriate methodology needed to determine each of these requires different expertise. If this is needed, the following section outlines how it should be done.



Complex Real Property Going Concerns

Complex real property going concerns are those that cannot usually be appraised using an improved property sales comparison approach since there are typically major differences between the Subject and the sales comparable data available. In these assignments, a real estate appraiser is needed to identify and conclude as to the value of the real property and the market value of a lease payment that would be paid to an independent third party if the real property were leased instead of owned by the entity. A business appraiser is needed to value the going concern after including the market lease expense in the Company income statements and in the income forecast developed for valuing the going concern portion of the real property going concern. The combined value of the real property as determined by the real estate appraiser and the going concern as determined by the business appraiser constitutes the fair market value (or market value) of the real property going concern.

Complex real property going concerns include, but are not limited to, the following property types:

- Amusement Parks
- Assisted Living Facilities (typically larger facilities)
- Convention Centers
- Hotels with Restaurants
- Nursing Facilities (typically larger facilities)
- Restaurant business entities that also own the real property
- Truck Stops
- And many other properties with integrated real property and businesses

The key to differentiate between the simple and the complex real property going concern is are there readily available improved and operating sales comparable data that is similar enough to the Subject to require little in the way of adjustments for differences. If so, the entity can be considered a simple real property going concern and can be valued by a competent and experienced real estate appraiser. If not, the entity will require both a business and a real estate appraiser.

Unfortunately, size alone of the entity does not determine if it is simple or complex. It is the nature of the entity and the availability of sales data for similar property sales and listings that define the difference. A major factor that directly affects the differentiation between a simple and a complex real property going concern is a comparison of the historical and expected financial performance of the entity as compared to the industry. The more different the Subject from the industry, the more likely it is to be a complex real property going concern.



It should be noted that there are significant differences between the methodology used to value real property and business entities. The risks associated with an income stream associated with the real property portion is typically much less than the income stream associated with the intangible business assets. Also, the income stream capitalized by real estate appraisers is much different than those used by business appraisers. Real estate appraisers typically capitalize net operating income – a pretax, before debt service, with no depreciation expense taken, income stream. Business appraisers typically capitalize net cash flow – an after-tax, adjusted for depreciation and capital expenditures, adjusted for changes in working capital, and it may, or may not, be adjusted for debt service.

Allocation of Value – Real Property Going Concerns

The fair market value of an operating company portion of a real property going concern should be determined after inclusion of a market lease expense for the real property owned by the Entity “as if” it were leased from an independent third party using standard business appraisal methodology. As part of this process, business appraisers are sometimes asked to allocate the value between tangible and intangible assets. It is important to note that the value of either the equity in the business or the value of the “assets that typically transfer in a sale” can be determined depending on the purpose and use of the appraisal. The market value of the real property is added to the value of the operating company in order to arrive at the value of the Real Property Going Concern. If the equity in the entity is the subject of the appraisal, any debt associated with the real property would be subtracted when the value of the real property is added.

This allocation of the value in a real property going concern is not always as simple as it appears. Depending on market conditions, industry conditions, the property type, and other factors, occasionally the real property’s value may exceed that of the value as a real property going concern or the value as a real property going concern may be less than the replacement cost new for the real property. In circumstances such as these, the appraiser’s job becomes more complex and the real estate appraiser and the business appraiser will have to work together to determine how much functional or external obsolescence should be allocated to the real property and how much intangible asset value may remain. For example, in an operating nursing home, the cost and time associated with licensing a facility likely has some intangible value even if total entity value is less than the replacement value of the real property.

It is often difficult to determine a market lease rate for the real property portion of a real property going concern. When valuing a complex real property going concern, I recommend that the real estate appraiser use both the cost approach (which includes the sales comparison approach for the land) with an improved sales comparison approach for similar properties that “have gone dark” as a sanity check. Ideally, the real estate appraiser will find similar real property that is leased to similar real property going concern entities, however, this is highly unlikely or if found, they are generally not



leased at “market” rates. Instead, once the value of the real property portion has been determined, the market lease rate must be determined by applying an appropriate lease rate factor to the value of the real property.

In order to determine the appropriate lease rate factor for the real property portion in a real property going concern, I have contacted a number of people actively involved build to suit leases and sale-leaseback of properties. Over a number of years, I have contacted various investors and lenders that are involved in sale-leasebacks of special purpose properties such as assisted living facilities and hotels. In this process, I determined that these rates are very similar to discount rates applicable to the same types of properties. There are a number of sources for discount rates. I prefer to use the quarterly Investor Survey published by RealtyRates.com as it is readily available, has been published for many years, and Robert Watts, the publisher of the survey, has agreed with me that the discount rates in his survey is a good proxy for sale-leaseback rates.

I apply the selected discount rate to the concluded market value of the land and improvements (determined by cost approach and confirmed by a sales comparison approach, whenever possible) to get the annual lease rate. This lease rate is assumed to be on a triple net basis, i.e. the tenant will also pay the property taxes, insurance, and all repairs and maintenance for the property. This market lease rate is then used by the business appraiser as an expense in order to determine the fair market value of the business portion of the real property going concern.

The combined value of the business portion (including the value of any personal property and intangible value) and the real property portion yields the value of the real property going concern.

Conclusion & Recommendation

Real estate appraisers should be careful in taking assignments to value real property going concerns. It is often not possible to find sufficient sales data to allow the appraiser to reach a supportable conclusion of value. Should this occur, the real estate appraiser should have a relationship with a competent business appraiser to allow them to complete the assignment in a manner that is USPAP compliant and that results in a credible conclusion of value that is well supported.

Real estate appraisers should be further cautioned that attending at a “course or two” will not provide them with the knowledge and experience requisite to value the business portion of a real property going concern, and that should they attempt to do so, they may very well step over the line into incompetence without realizing it. They should further consider the fact that their professional liability insurance policy very likely will not cover them when valuing businesses and real property going concerns certainly include a business. I am required to carry two professional liability policies – one for



real property and another for business valuation. It is interesting to note that the annual premium for the same amount of business valuation coverage is four times that of the real property annual premium. This indicates to me that the insurance companies view business valuation as much more risky than real property valuation.

In my years of appraising real property, personal property, and businesses, it is clear to me that business valuation is much more complex and subject to disputes and arguments than are real and personal property valuations. Valuing real property going concerns is very interesting and challenging work – be sure to be qualified for the work you take on or get someone to assist you that is qualified.

About the Author

Paul R. Hyde is a Master Certified Business Appraiser (MCBA), an Accredited Senior Appraiser (ASA) in both Business Valuation and Real Property – All Types, and an MAI designated real estate appraiser. He also is a Senior Appraiser designated by the American Society of Agricultural Appraisers for machinery & equipment and livestock appraisals. Paul appraises all sizes of businesses from large private businesses for Employee Stock Ownership Plans (ESOPs) to small mom and pop businesses for divorces. He also appraises all types of real estate. He specializes in appraising real property going concerns – combinations of businesses and real estate. He is the owner of Hyde Valuations, Inc., a business and real estate appraisal company in business since 1991. Initially, the firm started as a business brokerage and appraisal firm, but now does appraisals exclusively. Paul is Enrolled to Practice Before the Internal Revenue Service (Enrolled Agent)—a tax professional. He is the former editor of *Business Appraisal Practice*, the trade journal published by The Institute of Business Appraisers, Inc.

Prior to forming his own company, Paul worked as a commercial loan officer evaluating businesses and granting business loans. Paul later held the position of Chief Financial Officer and one-third owner of a twenty-seven unit restaurant company with a USDA meat processing plant for seven years. He has taught classes for a variety of organizations in business valuation, investments, tax planning, and small business management. Paul also served as an instructor for The Institute of Business Appraisers, Inc. for many years. He works full time in the business and real estate appraisal field. His contact is telephone at 208.722.7272 and email at prh@hydevaluations.com.

¹ L. Deane Wilson, MA, ASA and Robin G. Wilson, MAI, *Going Concern Valuation for Real Estate Appraisers, Lenders, Assessors, and Eminent Domain* (Bloomington: iUniverse, Inc., 2012)



ⁱⁱ David C. Lennhoff, MAI, SRA, Maureen Astroieni, MAI, and James D. Vernor, MAI, Ph.D., *Fundamentals of Separating Real Property, Personal Property, and Intangible Business Assets* (Chicago: The Appraisal Institute, 2011)

ⁱⁱⁱ Ben Wilcox, “Complexities in the Use of Real Estate Appraisals” Published in *Business Appraisal Practice: Journal of The Institute of Business Appraisers*, Spring 2008, p. 27 – 36.

^{iv} Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs, Valuing a Business: The Analysis and Appraisal of Closely Held Companies. Fourth Edition. (New York: McGraw-Hill, 2000), p. 914.