

REAL ESTATE “USE VALUE” IN BUSINESS ENTERPRISES

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The concept of “value” is paramount for the business and real estate communities. Vast sums of capital are committed based on opinions of value. Value is also a key component in litigation and taxation matters.

When valuing real estate and businesses, the most commonly used standard of value is that of “market value”. There are many definitions of “market value” such as the following from the Appraisal Instituteⁱ. Market value is:

The most probable price, as of a specified date, in cash, or in terms equivalent to cash, or in other precisely revealed terms, for which the specified property rights should sell after reasonable exposure in a competitive market under all conditions requisite to a fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under undue duress.

Most definitions of market value (or fair market value in the case of business valuation) represent the value of property *in exchange*. In other words, the value opinion describes the estimated amount at which a property should exchange between a hypothetical willing buyer and willing seller in the open market in an arm’s length transaction.

However, there are many situations in business and real estate valuation assignments where using the “value in exchange” principle is not the most appropriate standard to use. The valuation professional will rely on additional standards of value, such as “use value” in order to complete these assignments. The Appraisal Institute describes “use value” as: *the value a specific property has for a specific useⁱⁱ*, as opposed to the value in an exchange. This standard of value is often selected when the real estate is being valued as a component of a larger business enterprise.

The Appraisal Institute has been very careful to segregate the purpose and definitions of “market value” and “use value” in its publications to minimize confusion. However, to the non-appraiser, the statement that “use value is not market value” can be misleading. In fact, there is a subset of market participants who expect to use a property “as is” - in its current state. For them, use value is the same as market value. However, for other market participants, this is not the case. Perhaps the American Society of Appraisersⁱⁱⁱ stated it more clearly in a 1989 article:

Value-in-use is the market value of a going concern that reflects a value to a particular user, recognizing the extent to which the property contributes to the enterprise and/or profitability of the enterprise. Included in this value are installation costs, engineering design and layout fees, and miscellaneous cost savings resulting from an assembled operation.

Regardless of the definition, when estimating “use value” for real estate, the valuation analyst focuses on identifying the value that the real estate *contributes* to the enterprise, without regard for the hypothetical monetary amount that might be realized from a sale on the open market (in exchange). Consider the typical, older manufacturing plant occupied by a long-term tenant. There may be considerable “use value” to the tenant as a result of improvements made specifically to accommodate that tenant. However, the same manufacturing plant may have only a nominal value in the open market for another use. Conversely, if the current tenant were to move to another facility, significant investments above and beyond the original cost of the new property would likely be needed to satisfy the business requirements of the tenant. In this situation, it is in the tenant’s best interest to remain in the existing facility.

Although there are many assignments where the application of “use value” is appropriate, we will use a relatively common scenario for demonstration purposes. In the valuation of businesses, the business enterprise and the real estate used by the business enterprise are frequently owned by different, but related, ownership groups. As an example, the business enterprise may have several shareholders whereas the real estate occupied by the business may be owned separately by one of the shareholders. In this type of situation, the valuation analyst must determine rents that are reasonable and fair to both parties. Fair rent as determined under “use value” may differ greatly from that concluded using “market value”.

To illustrate the potential difference in rents between “use value” and “market value”, let’s assume that we have a situation in which an investor owns an existing manufacturing building with a current value on the open market of approximately \$4 million. The subject industrial building has been occupied for several years by a manufacturing company that requires the use of specific heavy duty equipment. As such, additional improvements with a depreciated value estimated at \$1 million have been made to the property over the years to accommodate the manufacturing tenant. These include, but are not limited to: additional electricity lines to power the equipment, additional plumbing which serves the equipment, hardened flooring, additional lighting, and heavy-duty overhead cranes. The lease in place is near expiration. The valuation professional must determine the fair rent.

For this situation, we assume that an appropriate annual rate of return to the real estate owner/investor is 10% based on a fifteen year lease. The property is expected to appreciate approximately 2% annually given that the tenant is required to maintain the property adequately. Further, at the end of the 15 year lease holding period, it is anticipated that the property will be placed on the open market for sale and the improvements made specifically for the current tenant will have minimal economic value. In reality, some improvements may have a ready market for long periods of time while other improvements, such as technology, grow obsolete rather quickly.

Based on the preceding assumptions (simplified for the purposes of this example), the following table illustrates that a fair rent based on the “use value” assumption is \$444,000 annually, while the rent based on a typical “market value” (in exchange) assumption is \$324,000 annually. Thus, the manufacturing company tenant would pay an additional \$120,000 (37% annually) in rent to accommodate the improvements needed to serve ongoing business operations.

Difference in Market Rents Due to Difference in Value Premise

Market Value of Property in Exchange	\$4,000,000	
Estimated Depreciated Value of Tenant Specific Improvements	<u>\$1,000,000</u>	
Cost of Property for Specific Tenant	\$5,000,000	
Anticipated Annual Growth in Property Value	2.0%	
Required Annual Rate of Return to Investor (a.k.a. Yield or Discount Rate)	10.0%	
Holding Period or Lease Period for Investor in Years	15	
	<u>Market Value</u>	<u>Use Value</u>
Initial Investment in Property	\$4,000,000	\$5,000,000
Exchange Value of Property after 15 Yr Holding Period @ 2% Annual Growth	\$5,383,000	\$5,383,000
Annual Rent Payment to Investor Required to Support 10% Rate of Return*	\$324,000	\$444,000
Incremental Rent Payments Due to "Use Value" Premise	\$120,000	
% Difference	37.0%	

* *Payment made at the beginning of each period*

In an actual lease negotiation, the current tenant would likely argue that the existing improvements have already been paid for in the prior lease and that the new lease shouldn't include the value of the improvements. On the other hand, the landlord might point out that if the tenant were to move to a different facility, the cost of providing the necessary improvements to the new site would be greater than the value of the existing improvements. Additionally, the tenant would incur both moving costs and a loss of profits from downtime during the move. All of which make the existing facility more attractive. As one might expect, the results of a lease negotiation are highly dependent upon the situation-specific details.

Value conclusions can differ significantly depending upon the standard selected. Although the principle of "use value" is not as widely understood or practiced in the appraisal community as "market value", it is of equal importance. The competent valuation expert understands the differences and similarities between "use value" and "market value" and must articulate these assumptions to the client. In cases where a market may exist for the special use property (such as an automobile dealership) or the business is dependent upon the real estate for its earnings (such as a golf course) the real estate may take on the value of the tenant specific improvements. In these types of valuations, "use value" may be synonymous with "market value", whereas in other situations, the value conclusions differ. Regardless, it is the responsibility of the business and real estate valuation experts to properly identify the type of value assumed in each analysis.

As one of the few firms in the country specializing in the valuation business enterprises as well as commercial real estate, Shenhon Company is uniquely positioned to solve valuation problems that involve both business and real estate components such those discussed in this article.

¹ *The Appraisal of Real Estate Thirteen Edition*, The Appraisal Institute, Chicago, 2008, p.23.

² *The Appraisal of Real Estate Thirteen Edition*, p. 27.

³ *The Opinion Of The College On Defining Value in Use*, John L. Gadd, Valuation - Volume 34, American Society of Appraisers, Virginia, 1989.