Valuation Viewpoint

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CHANGES IN EMINENT DOMAIN LAW
MINNESOTA IS MOVING IN THE RIGHT DIRECTION

BY: ANDREW T. DONAHUE AND JOHN T. SCHMICK

The Constitution grants government the power of Eminent Domain: the right to take private land for public use. In return for taking private property, the condemning authority must provide just compensation to the owner. Most of us are familiar with the many public-use projects such as highways, roads, utilities, schools, hospitals and the like, where private land is taken for public use. Increasingly however, cities have allowed the use of condemnation for private-use projects (economic redevelopment). When commercial developers cannot acquire the land parcels they want using traditional means, they ask the city to use its power of Eminent Domain to condemn the land and acquire it for private development. Thus, one private enterprise is permitted to take land from another for private, not public use. Indeed, the U. S. Supreme Court's decision in the Kelo Case (2005) essentially confirmed that the government does have the power to take private property for whatever reason it deems necessary. At the same time, however, the Court indicated that states have the right to enact their own laws governing Eminent Domain procedures.

If a government entity can take personal property from one owner and give it to another for non-public purposes, what protection does the individual real property owner have? In response to citizen outrage over the Kelo decision, many states began the process of re-evaluating and re-structuring their own Eminent Domain laws. In 2006, Minnesota joined this growing number of states and modified its Eminent Domain procedures to offer some protection to individual real property owners and to provide a modicum of fairness to the application of the law.

continued on page 7

MARKET TRENDS AND INDICATORS

Office Buildings	↑	1%
Retail Centers	↑	3%
Industrial Buildings	↑	2%
Apartments	↑	2%
New Housing Starts	↓	.84%
Productivity	↓	1.5%
Composite PE	↑	24.7
Consumer Confidence Index	↓	105.7

In This Issue ...

MARKET TRENDS AND INDICATORS

ECONOMIC INDICATOR

	2000	2001	2002	2003	2004	2005	3Q 2006
New Housing Starts—Yearly Totals	317,500	330,400	349,600	374, 100	355,700	357,400	224,900

*Midwest Region re-defined in 2002

P/E RATIOS IN SELECT INDUSTRIES

Reporting categories changed in spring of 2006. Data for the new categories is presented for May through December of 2006.

Industry (Year end)	May 06	Jun 06	Jul 06	Aug 06	Sep 06	Oct 06	Nov 06	Dec 06
Basic Materials	14.94	15.07	14.63	13.0	12.98	13.35	11.80	12.16
Conglomerates	20.50	19.56	19.65	18.75	17.65	18.98	20.20	20.12
Consumer Goods	26.19	30.00	28.88	23.41	26.92	30.85	34.00	24.61
Financials	15.29	15.74	15.67	13.81	14.09	14.59	14.44	14.22
Healthcare	47.83	38.53	41.76	47.57	41.01	34.17	39.18	44.75
Industrial Goods	33.26	30.82	30.27	26.54	28.47	21.40	16.40	16.69
Services	27.58	27.81	24.79	27.21	26.24	26.83	24.83	23.82
Technology	24.67	28.46	28.41	29.13	28.35	27.83	26.75	27.64
Utilities	18.30	17.27	16.93	28.97	36.79	34.89	34.82	31.34

All Industry Composite P/E Ratios	**25.07**	**24.13**	**24.5**	**24.63**	**25.83**	**24.76**	**24.71**	**23.91**

ECONOMIC INDICATORS

Indicator (5 yr. avg.)	1985	1990	1995	2000	2004	2005	2006
Inflation	5.0%	4.0%	3.1%	3.4%	2.7%	3.4%	2.0%
Productivity	1.7%	0.6%	1.5%	2.9%	4.0%	1.8%	1.5%
GDP	4.0%	1.8%	2.7%	3.8%	4.4%	3.5%	3.2%
Consumer Confidence	84.9	104.2	99.2	128.6	104	107.2	105.6

RATES OF RETURN AND RISK HIERARCHY

Investment	Current
30 Year Treasury	4.8%
Aaa Bond	5.4%
Bbb Bond	6.1%
Commercial Mortgage	5.5–6.5%
Institutional Real Estate	7–8%
Non-Institutional Real Estate	8.5–10.5%

Investment	Current
Speculative Real Estate	11–15%
S & P Equity (Ibbotson)	11.9%
Land Development	13–18%
Equipment Finance Rates	14%
NYSE/OTC Equity (Ibbotson)	15.9%
NYSE Smallest Cap. Equity (Ibbotson)	21.75%

Sources: National Real Estate Index (2007), Appraisal Institute; F.W. Dodge Division, Business Week, Value Line, U.S. Chamber of Commerce, Standard & Poors, Investment Dealers Digest, U.S. Government Census, Yahoo Finance.

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IDENTIFY THE ASSET CLASS THEN APPLY THE APPROPRIATE DISCOUNT

BY: SCOT A. TORKELSON

Introduction

The relationship between risk and the applicable lack of control and lack of marketability discounts is a crucial part of the valuation of partial interests in holding entities. A common error among practitioners is the misapplication of lack of control discounts from one asset class to another. For example, lack of control discounts developed from data for operating companies may be erroneously applied to the asset class of marketable securities or the asset class of real estate holdings. Accurate risk assessment depends on using an asset-class-appropriate discount rate. Following is a discussion of various discounts based upon asset class with comparison charts to illustrate the differences.

Lack of Control Discount

According to the Business Valuation Committee of the American Society of Appraisers, the term "minority discount" or "lack of control discount" is defined as "the reduction, from the pro rata share of the value of the entire business to reflect the absence of the power of control." The reverse of a lack of control discount is a control premium, as witnessed when a controlling interest in a company is purchased. Control premiums have been further studied as a basis for determining and justifying lack of control discounts for the various asset classes: operating companies, real estate holdings, and marketable securities.

Asset Class: Operating Companies—The studies for lack of control discounts most commonly look to the public markets. One study, published by W. T. Grimm and Partnership in *Mergerstat Review*, has been conducted for each year from 1990 to 1999. All public partnership control acquisitions of another partnership reported in each year were analyzed. Some years recorded up to 1,700 such transactions which supplies a strong database for their analysis. Over this ten-year period, according to the Grimm Study, the average premium paid over market ranged from 35.1% to 44.7%, implying lack of control discounts of 26% to 30.9%.

Following is a representation of discounts from the Mergerstat Study, 1990 to 1999. Another study, published by Houlihan, Lokey, Howard, & Zukin, Inc. (HLHZ), analyzed 218 transactions in 1986 and 1987 and found average implied discounts of 29% to 33%, respectively.

MERGERSTAT REVIEW—OPERATING COMPANIES

Year of Buyout	Number of Transactions	Control Premiums		Implied Lack of Control Discounts	
		Averages	*Medians*	*Averages*	*Medians*
1990	175	42.0%	32.0%	29.6%	24.2%
1991	137	35.1%	29.4%	26.0%	22.7%
1992	142	41.0%	34.7%	29.5%	25.8%
1993	173	38.7%	33.0%	27.9%	24.8%
1994	260	41.9%	35.0%	29.5%	25.9%
1995	324	44.7%	29.2%	30.9%	22.6%
1996	381	36.6%	27.3%	26.8%	21.5%
1997	487	35.7%	27.5%	26.3%	21.6%
1998	512	40.7%	30.1%	28.9%	23.1%
1999	723	43.3%	34.6%	30.2%	25.7%

Asset Class: Real Estate Holdings—In studies developing the applicable lack of control discounts for real estate holdings, the data is frequently developed from Real Estate Investment Trusts (REITs).

In one such study, conducted by Lance Hall and published May 1993, discounts for REIT properties averaged from four points to twenty-four points lower than lack of control discount rates for operating businesses (averaging 12 points lower over the entity's period) over the same period 1982 to 1991 meaning that the average discount for REITs over this period has been proximate to 22%. Thus there has been tremendous variability in market-derived discounts for REIT properties over the period, from a low of -5% lack of control discount in 1985 to a high of -40% lack of control discount in 1991. However, throughout this period, the discount for lack of control for REITs has been consistently lower than for operating companies (fig. 1).

Asset Class: Marketable Securities—The source of comparison for the development of lack of control discounts applicable to marketable securities can be found in closed-end funds and is provided by Morningstar, Inc. Morningstar is among the leading sources of data for such closed-end investment companies and is considered to be similar to what Standard & Poor's provides for the public stock and bond markets. We consider the data derived by Morningstar to be as reliable as Standard & Poor's.

The difference between NAV (Net Asset Value) and market price for closed-end funds has trended in a narrow range from -2% to -13% over the past fifteen-years, averaging approximately 7.5%, or trending at approximately one-half the long term lack of control discounts indicated for REITs (fig. 2).

Lack of Control Discounts for Marketable Securities

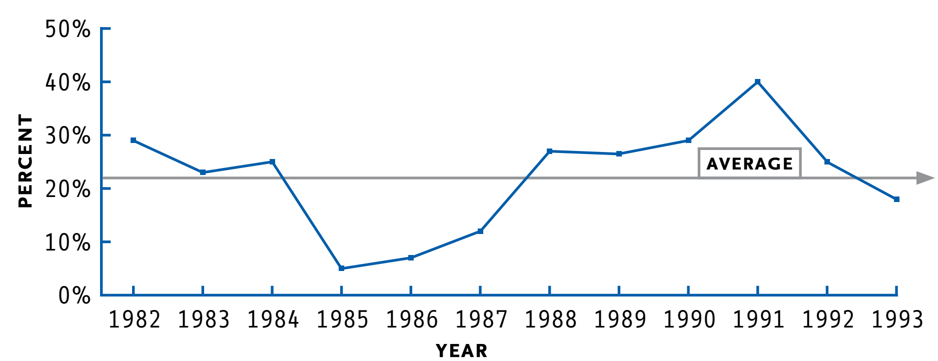
Based upon these studies, the overall lack of control discounts for operating companies ranged from 26% to 33%. REITs, which relate to the real estate portions of a partnership, have ranged from 15% to 22%. For the closed-end investment funds, the data range from 6% to 12% for domestic equities at this time.

Risk and Return

The relationship between risk and the applicable lack of control discount is a crucial part of the valuation of partial interests in holding entities. As mentioned earlier, a common error among practitioners is the inappropriate application of lack of control discounts

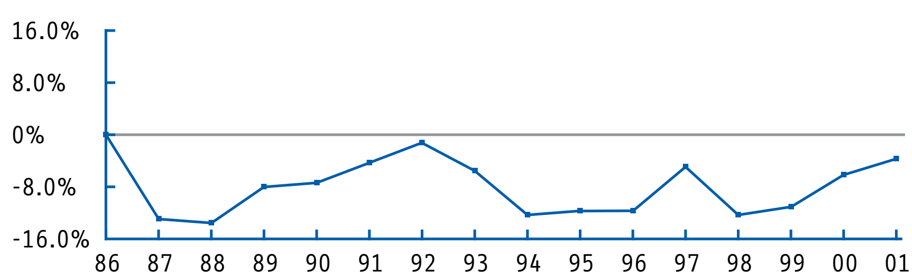
fig. 1

MINORITY INTEREST DISCOUNT *from Publicly Traded REITs*



From Lance Hall Study, 1993. Including updated data for 1992 and 1993.

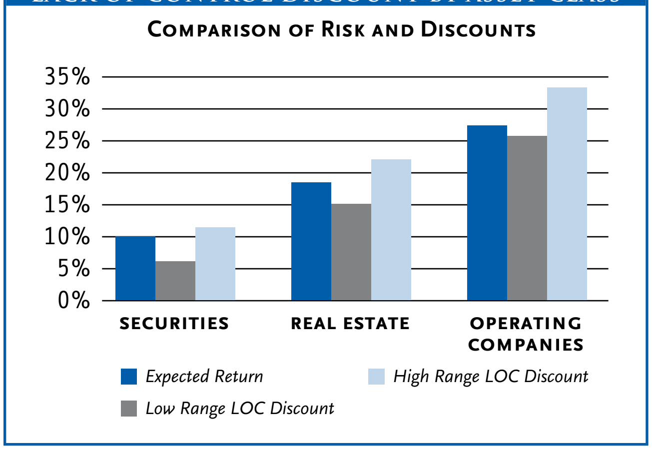
fig. 2



Source: Herzfeld Closed-End Fund Average. All data from last week in December.

from one asset class to another. For example, the lack of control discounts from operating companies may be incorrectly applied to the asset class of marketable securities. The relationship of risk and lack of control discounts is demonstrated in the following chart. Expected returns were developed from Ibbotson Associates data available at this time.

LACK OF CONTROL DISCOUNT BY ASSET CLASS



As can be readily seen, the anticipation of higher returns is associated with higher risk in the marketplace, and the impact upon perceived risks on the absence of control reflects a higher discount as well. Simply stated, as an asset class becomes riskier the perceived need to control the assets becomes greater, and the disinclination for a partial interest leads to the higher applicable discounts. If an asset is perceived to be lower risk, then the danger of owning a partial interest is also lower as control becomes less of an issue. Thus, the disinclination of owning a partial interest in such an asset class is also less. Conversely, the ownership of a start-up company with high risks results in more dependence upon the management and its ability to control or direct the company. This inability by a partial owner to effect control in such higher risk enterprises results in the highest lack of control discounts.

Inferential Application to Lack of Marketability

The most common method of establishing lack of marketability discounts for non-controlling interests in stocks is to look at the discounts for a publicly-traded stock which has had blocks of its stock restricted from open market sales. §144 Restricted Securities are also called *letter stock*. Letter stock is, therefore, identical to freely-traded public stock except that it is restricted from trading publicly for a specified period. Letter stock is typically issued when companies issue new stock or when (as in corporate acquisitions) registration of such stock with the SEC is not practical because of costs at the time or timing in the market.

Again, it must be noted that such a discount cannot be randomly applied to any given investment, due to the fact that all equities, from the lowest to highest risk stocks, were examined in this study. Further, data from the letter stock focuses upon operating companies. The same misapplication cautions must apply for lack of marketability discounts as for lack of control discounts; identify the asset class, then apply the appropriate asset class discount.

The most noted original lack of marketability discount study was conducted in the 1970s by investment banker Robert E. Moroney, "Most Courts Overvalue Closely Held Securities," published in *Taxes—The Tax Magazine*, March 1973. His study examined 146 individual blocks of restricted equities. These blocks were discounted from 10% to 90% from their counterpart unrestricted securities. The average discount was 35.6%. Additional studies since this landmark study have essentially supported the conclusions of the Moroney study. Among these, Mr. Michael J. Maher published a study in September 1976, with the mean marketability discount for restricted stock at 35.4%. In yet another study, conducted in 1991 by Mr. Silber, the

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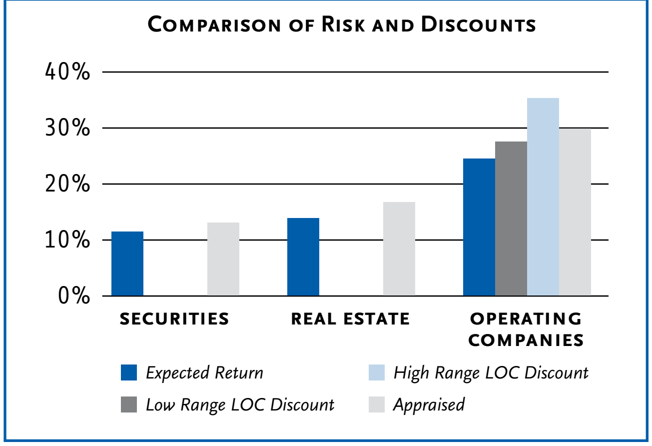
mean marketability discount for restricted stock was 33.8%. The most recent study, completed by Management Planning, indicated a mean discount of 27.7% and a median discount of 28.9%. Thus, the results of numerous §144 Restricted Securities analyses, show that the average for lack of marketability discounts has remained in a fairly narrow range from 28% to 36% for operating companies.

All of the studies previously discussed were for operating companies exclusively, a class of assets with a considerable goodwill component and considerably higher risk than other asset classes. While the data considered can be useful it must be appropriately adjusted to the asset class being valued.

With respect to quality and risk factors, real estate rates of return typically range from 10% to 14% annually (average of 12%) as of the current date, whereas return rates for operating companies, for example, range from a low of 18% for highly secured small capitalization companies to in excess of 35% (average of 25% shown on chart below - dark blue bar) for operating companies with extensive levels of goodwill. The publicly available information pertaining to marketability discounts is based upon these types of operating companies with much higher risk and therefore the expected higher yield levels required to attract investors. We estimate the lack of marketability discount for the asset class of real estate holdings at approximately a 15.0% lack of marketability discount, rather than the range of from 27.5% to 36% indicated for operating companies (dark gray and light blue bars). Data for marketability discounts is only available for operating companies, thus we must adjust these for the lower risk asset classes. We have estimated a reasonable lack of marketability discount from the available data for each asset class (light gray bar).

"When asset-class-appropriate discounts are applied, the assessment of risk is supportable."

LACK OF MARKETABILITY DISCOUNT BY ASSET CLASS



Conclusions

The application of discounts relative to the differing risk levels of asset classes is well-supported in the lack of control discount analyses where more precise data is available. We are of the opinion that the same relationship exists within the area of lack of marketability where such precise measures among the asset classes is unavailable. As can be seen in the previous chart, the lower risks of the marketable securities asset classes (cash equivalents) and the real estate asset classes result in a downward adjustment in the lack of marketability discounts indicated for operating companies.

The data provided in this article draws from a variety sources applicable to the various asset classes. In each instance, the specific partial interest holdings must be considered along with the current value date. The figures presented here should not be construed as the numbers to be used for these various asset classes in all cases. Rather, in this article, we are attempting to show the significance of the differences in discounts among the various asset classes. When asset-class-appropriate discounts are applied, the assessment of risk is supportable. The common error of misapplication of discount data from one asset class to another must be avoided. VV

continued from page 1

Many of our appraisers and analysts attended a Continuing Legal Education seminar in which various aspects of the new Minnesota laws were discussed. Certain terms, conditions and methodologies were clarified. This article focuses on four of them:

- takings for economic development
- compensation for loss of going concern
- compensation for relocation
- reimbursement of professional fees

In general, the reader may assume that public-use projects (roads, utilities, and other municipal building projects) will continue to be approved by the courts, as they have in the past. The changes discussed herein affect primarily takings intended for private use.

Takings for Economic Development

One of the most notable changes deals with the parameters of a taking for economic development. In the past, a city had the power to designate an entire area as blighted or contaminated and proceed to acquire all the properties with the idea that new developments would increase the city's tax revenues. Prescriptive standards and definitions have now been added to the appraisal and negotiation requirements of a taking. Consequently, blanket description takings (all of the properties within a defined area) are no longer permitted. The terms blight and contamination are now applied to each individual property and include the requirement that more than 50% of the properties designated for a taking must meet the criteria for 'structurally substandard' or contaminated.

> "*Increasingly however, cities have allowed the use of condemnation for private-use projects (economic redevelopment).*"

Structurally substandard is defined as "a building that was inspected by appropriate local government authorities and *cited* (emphasis added) for one or more enforceable housing, maintenance, or building code violations". While the definition provides specific reference to building components, the key factors of the approved definition are that the code violations have not been cured despite two notices of non-compliance and that the cost to cure the violations "would cost more than 50 percent of the assessor's taxable market for the *building*, (emphasis added) excluding the land". Further, the new law now describes an "environmentally contaminated " area as one where 50% of the parcels contain contamination and the estimated cost of dealing with that contamination is more than the assessor's estimated market value for each parcel.

> "*Consequently, blanket description takings (all of the properties within a defined area) are no longer permitted.*"

The practical reality of this definition is that homeowners and other building owners must be given a chance to bring their properties up to code in order to avoid having their properties designated as blighted or contaminated for condemnation purposes. In order to determine if the government has met the required 50% threshold necessary to establish blight/contamination, property owners must now obtain cost-to-repair estimates, appraisals and, perhaps, legal counsel. Still unresolved is who pays for these expenses. Restricting the use of blight or contamination as the basis for a taking gives private property owners some small measure of control over the taking process.

The new law also established, for the first time, a public hearing requirement for proposed condemnations involving blighted areas or environmentally contaminated areas. The local governing body must hold such a hearing and then wait at least 30 days before approving the taking. The resolution of approval must identify the public costs and benefits of the project, as well as state how the acquisition serves a public use and why the property is needed. In addressing a major sore spot for many property owners, the new law requires the condemning authority to sell the property back to the former owner at the lower of the original price or the current fair market value if the condemning authority determines that the property has not been used for public use or is no longer needed for a public use. Unfortunately for property owners, this particular rule applies to some, but not all government entities. Finally, when a taking is approved, the relocation assistance package, once determined almost exclusively by the condemning authority, will now be set forth by an independent administrative law judge if the displacing person does not accept the condemning authority's offer.

> *"The new law also established, for the first time, a public hearing requirement for proposed condemnations involving blighted areas or environmentally contaminated areas."*

A note of caution: the new law does provide a "feasible alternative" clause for the condemning authority. Specifically, the law reads "condemning authorities must not take buildings that are not structurally substandard *unless* (emphasis added) there is no feasible alternative to the taking...in order to remediate the blight..." Essentially, this gives government the right to go forward with a project even if some of the properties in the designated area are not blighted. However, the burden to minimize the taking of buildings that are not substandard or contaminated rests with the government entity, not with the owner.

Compensation for Loss of Going Concern

Minnesota's Eminent Domain law now recognizes the necessity of compensating owners for loss of going concern. This refers to the loss of business value and includes losses for both owners and tenants. The changes to Section 117.186 are likely to generate a fair amount of controversy. The most challenging part of this section will be interpreting the first sentence of subdivision 2: "If a business or trade is destroyed by a taking, the owner shall be compensated for the loss of going concern…" The law previously provided no compensation for business loss except in very limited circumstances. The new law requires that the owners and/or tenants receive compensation for the loss of a going concern if the business is destroyed as a result of the taking, unless the condemning authority proves by the preponderance of the evidence that the loss is not due to the taking. As yet undetermined is how one assesses whether the business is destroyed. When an owner or tenant seeks damages as a result of a loss of going concern, what objective criteria will be used to make that judgment?

An owner seeking damages for loss of going concern must give notice to the condemning authority within 60 days of the first court hearing. Additionally, sufficient documentation relating to the loss must be given to the opposite party at least 14 days prior to the hearing. Moreover, when an owner or tenant is forced to relocate, the amount of damages payable must be *sufficient to purchase a comparable property in the community* (emphasis added). The condemning authority may not, however, require an owner to accept a substitute or a replacement property as part of the compensation due. Further, the condemning authority

> *"Minnesota's Eminent Domain law now recognizes the necessity of compensating owners for loss of going concern."*

must reimburse the owner or tenant up to $50,000 in re-establishment expenses.

Compensation for Relocation

Unfortunately, there is no clear definition of 'community'. If the property is taken in the city of Richfield, does this mean a replacement property must also be within the city of Richfield? We anticipate that the government will no longer be able to require a property owner to move across the metro area to relocate. A decision as to what constitutes a reasonable relocation will have to come from the courts. In addition, if a replacement property costs more than the property taken, it appears that the higher number will qualify as the minimum compensation. A project such as the Best Buy development in Richfield, where numerous small businesses lost their properties, is a prime example of the dilemma of relocation within a community. All of these owners were in the same market at the same time looking for the same type of replacement property. Basic economics tells us that when supply is limited and demand suddenly increases, prices for comparable properties will escalate. It becomes a seller's market.

> "*All of these owners were in the same market at the same time looking for the same type of replacement property.*"

The condemning authority must also pay compensation, not to exceed three years' previous revenues, minus the cost of goods sold, if the government permanently eliminates 51% or more of the driveway access to a business and that removal results in a loss of revenue of 51% or more for that business.

While business owners now have the opportunity to receive compensation for the loss of their businesses, it appears that the threshold to qualify for that compensation is quite high. What happens to the business that suffers only a 40% loss of its defined revenues? Clearly there would be a loss of value in real economic terms but no avenue for compensation. We anticipate that the courts and/or the legislature will have to clarify this section. We also suspect that there will be a fair amount of litigation on the topic before the question reaches the Minnesota Supreme Court.

Reimbursement of Professional Fees

The guidelines for reimbursement of professional fees also changed dramatically. Prior to the changes enacted in 2006, a property owner was entitled to reimbursement of appraisal fees (from the condemning authority) up to $1,500 regardless of how much it actually cost the owner to hire an appraiser. Despite the fact that many government officials recognized how unfair this limitation was to property owners, few supported a change in the law. The new bill attempts to address the unfair advantage the condemning authority has over the property owner in obtaining an appraisal. Section 117.036 (2b) states: "an owner is entitled to reimbursement for the reasonable cost of the appraisal ...up to a maximum of $1,500 for a single family or two-family residential property and *minimum damage acquisition* (emphasis added) and up to $5,000 for other types of property..." A minimum damage acquisition is defined as "an interest in property that a qualified person with appraisal knowledge indicates can be acquired for a cost of $10,000 or less." The problem with the definition for minimum damage acquisition is that appraisers often do not agree on value esti-

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mates. Most of the litigation surrounding Eminent Domain takings is based on the fact that the property owner does not agree with the compensation for damage offer. It is likely that this $10,000 threshold will be a source of disagreement as will the low level of reimbursement for appraisal fees in these types of acquisitions.

Finally, in yet another remarkable departure from the previous law, Minnesota law now allows a court the *discretion* (emphasis added) to award attorneys' fees if the final award is between 20 and 40% higher than the condemning authority's last written offer before filing the condemnation petition. If the award is more than 40% greater, the court *must* (emphasis added) award attorneys' fees. However, no attorneys' fees will be paid if the final award is less than $25,000, which is defined as a minimum damage threshold. This type of reimbursement schedule has long been sought as a means to bring some fairness into the Eminent Domain process. Perhaps the condemning authorities will view the new guidelines as incentives to reach an agreement on the value of compensation with the property owner in takings cases in order to avoid costly litigation. Given the adversarial nature of most Eminent Domain proceedings, we anticipate that the government will not accept a fixed fee appraisal contract as 'reasonable'. Reasonable fees are likely to be based on the amount the government pays its expert. Those contracts are usually awarded to the lowest cost bidders and reflect economies of scale for appraising multiple properties at one time. Generally, they do not reflect appraisal fees available to individual property owners for appraisal services in the marketplace.

> *"All in all, these are extraordinary changes: steps in the right direction."*

Conclusion

In this article, we commented on some of the changes to Eminent Domain laws enacted by the Minnesota Legislature in 2006. Certainly, there are other details within the new law that may be applicable to individual takings cases. All in all, these are extraordinary changes: steps in the right direction. The new law more fairly and accurately recognizes the extent of the burden a taking places on the property owner as well as the true costs of public and private projects that use the Eminent Domain law to acquire property. We encourage our readers to contact their attorneys whenever a taking is proposed and to be aware that the new changes may require that appraisers be brought into the Eminent Domain process much earlier than in the past. VV

MARKET TRANSACTION: BUSINESS VALUATION

will return in the next issue of *Valuation Viewpoint*.

MARKET TRANSACTION: REAL ESTATE

Property:	Wells Fargo Place
Buyer:	Unilev
Seller:	Zeller-World Trade LLC
Source:	Buyer
Sale Date:	August 14, 2006
Sale Price:	$106,000,000
Unit Price:	$161.81/sq. ft. (NRA)
Net Rentable Area:	655,095 square feet
Gross Building Area:	853,139 square feet
Zoning:	B-4, Central Business District
Utilities:	All available
Topography and Soil:	Generally level; good
Visibility and Access:	Good
Age:	1987
Land Size:	110,041 square feet
Remarks:	The property was 85% leased at the time of sale. There were three potential tenants looking to lease approximately 50,000 square feet. If these and several other contract proposals were executed, occupancy would be close to 98%.

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Shenehon Company is a Real Estate and Business Valuation firm, serving both the private and public sectors throughout the United States. Our unique combination of real estate and business valuation expertise allows us to provide a wide range of services and to offer innovative solutions to difficult valuation issues. Obtaining accurate and reliable industry information and expertise should play a key role in any decision-making process, and Shenehon Company is dedicated to equipping its clients with the tools necessary to make informed and knowledgeable decisions regarding their capital investments.

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