Valuation Viewpoint

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REAL ESTATE "USE VALUE" IN BUSINESS ENTERPRISES

BY: CHARLES A. MILLER

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 Institute.[1] 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 profes-

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MARKET TRENDS AND INDICATORS

Office Buildings	↓	20%
Retail Centers	↓	30%
Industrial Buildings	↓	10%
Apartments	↓	5%
New Housing Starts	↓	35%
Productivity	↑	2.8%
Composite PE	↑	18.7
US Unemployment	↑	8.1%
Consumer Confidence Index	↓	56.6

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MARKET TRENDS AND INDICATORS

ECONOMIC INDICATOR

	2002	2003	2004	2005	2006	2007	2008
New Housing Starts—Yearly Totals	349,600	374,100	355,700	357,400	279,500	211,700	136,500

P/E RATIOS IN SELECT INDUSTRIES

Reporting categories changed in spring of 2006. Data for the current categories is presented for the Years: 2006, 2007, and 2008; monthly for 2009 to date; and 1Q 2009.

Industry (Year end)	2006	2007	2008	Jan 2009	Feb 2009	Mar 2009	1Q 2009
Basic Materials	13.7	14.1	15.2	8.9	8.7	9.2	8.9
Conglomerates	20.1	18.4	15.8	12.5	9.6	9.5	10.5
Consumer Goods	25.8	24.4	16.3	16.0	13.2	14.4	14.5
Financials	14.3	13.7	11.7	18.0	11.0	9.4	12.8
Healthcare	38.8	40.0	26.0	21.6	41.9	41.1	34.9
Industrial Goods	25.1	19.5	19.5	19.3	12.9	16.7	16.3
Services	25.6	28.7	24.2	21.6	21.0	15.4	19.3
Technology	26.3	38.4	23.8	12.4	13.3	12.7	12.8
Utilities	24.0	20.0	15.3	22.2	13.1	10.3	15.2
Composite	**24.4**	**24.0**	**18.7**	**16.3**	**16.1**	**15.4**	**15.9**

ECONOMIC INDICATORS

Indicator (5 yr. avg.)	1985	1990	1995	2000	2005	2006	2007	2008
Inflation	5.0%	4.0%	3.1%	3.4%	3.4%	2.0%	4.1%	3.8%
Productivity	1.7%	0.6%	1.5%	2.9%	1.8%	1.5%	1.6%	2.8%
GDP	4.0%	1.8%	2.7%	3.9%	2.9%	2.8%	2.0%	1.3%
Consumer Confidence	84.9	104.2	99.2	128.6	107.2	105.6	87.9	56.6

UNEMPLOYMENT

	1990	1995	2000	2005	2006	2007	2008	Feb 2009
US	**5.4%**	**5.6%**	**4.0%**	**5.2%**	**4.7%**	**4.6%**	**4.9%**	**8.1%**
Northeast	5.0%	6.0%	4.0%	4.9%	4.7%	4.4%	4.7%	7.7%
Midwest	5.7%	4.5%	3.5%	5.7%	5.1%	5.0%	5.3%	8.6%
South	5.4%	5.4%	4.0%	5.2%	4.6%	4.3%	4.6%	8.1%
West	5.1%	6.6%	4.6%	5.5%	4.8%	4.5%	5.2%	9.2%
Minnesota	**4.6%**	**3.6%**	**2.9%**	**4.5%**	**4.2%**	**4.5%**	**4.8%**	**8.1%**

RATES OF RETURN AND RISK HIERARCHY

Investment	Current
30 Year Treasury	3.6%
Aaa Bond	5.95%
Bbb Bond	7.1%
Commercial Mortgage	6.75–7.75%
Institutional Real Estate	7.5–9.0%
Non-Institutional Real Estate	10–12.2%

Investment	Current
Speculative Real Estate	14–18%
S & P Equity (Ibbotson)	10.7%
Land Development	20–25%
Equipment Finance Rates	12.5%
NYSE/OTC Equity (Ibbotson)	14.3%
NYSE Smallest Cap. Equity (Ibbotson)	20.4%

Sources: National Real Estate Index (2009), 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, Bureau of Labor Statistics.

RULES OF THUMB:
WHAT IS THEIR ROLE IN BUSINESS VALUATION?

BY: HEATHER M. BURNS

Introduction

Business valuation professionals are routinely engaged to value complex business enterprises in a diverse range of industries. The business appraiser analyzes the subject entity's past performance, calculates the current worth of its tangible and intangible assets, estimates its earnings capacity and compares it to sales of similar businesses in order determine the entity's value at a specific point in time. In addition to the standard valuation techniques (asset approach, income approach and market approach), industry-specific rules of thumb are often analyzed and, sometimes, incorporated into the appraisal report.

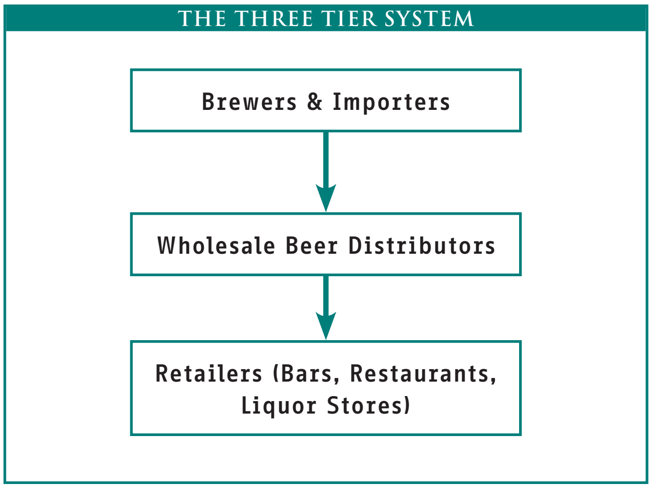
Rules of Thumb

Rules of thumb are industry-specific pricing guidelines detailed in various professional journals and books. These publications also provide general information, pricing tips and resources by industry. Rules of thumb exist for many, although not all, types of businesses and they vary by industry from multiples of sales or EBITDA (earnings before interest, taxes, depreciation and amortization) plus asset categories (such as shuttle service businesses estimated at 3 times EBITDA plus the value of the vehicles), to industry specific metrics (such as telecommunications businesses estimated at $700 to $1,400 per line). For purposes of illustration, we use a beer distribution business as an example of specific pricing guidelines in an industry. Further, we discuss the industry dynamics, traits specific to the subject business and application of the rules of thumb established for the industry.

"*Rules of thumb are industry-specific pricing guidelines detailed in various professional journals and books.*"

Industry Dynamics

The business appraiser first thoroughly researches the subject industry in order to understand the environment in which the subject business operates. In our example, the subject business is a beer distributor operating within the United States. Beer distributors in the U.S. operate in a unique regulatory environment established by state and federal governments as a result of the 21st Amendment to the Constitution. Since the end of prohibition over 75 years ago, malt beverages in the U.S. have been distributed according to a three tier system consisting of: licensed suppliers (brewers and importers), wholesale beer distributors, and retail establishments. The distributor acts as an intermediary between brewers and importers on one side and bars, restaurants and liquor stores on the other. The distributor provides warehousing and delivery enabling brewers and retailers to keep inventory and storage costs low, it has a territory monopoly for the brands it distributes and, by law, it cannot be bypassed by the brewers or importers going directly to the retailer. Additionally, the distributor takes on retailer nonpayment risk, is responsible for product freshness and facilitates the recording and collection of state and local taxes. The mature U.S. beer industry is characterized by industry consolidation and a unique system of competition where distributors obtain exclusive rights to distribute specific brands of beer within a defined territory.



Traits Specific to the Subject Business

Once the appraiser understands the industry in which the subject business operates, the focus shifts to how the specific business operates and what traits make it different from the typical business in the industry. In order to analyze the subject business, the appraiser interviews management, tours the business facility and reviews the subject's historical balance sheets and income statements. A financial statement analysis helps the appraiser to identify positive or negative trends within the business enterprise over time and to see how the subject compares to other businesses in its industry. Often, a comparison between the subject business and its peer group is completed through the use of company data compiled by organizations like the Risk Management Association (RMA). These published studies group companies within an industry by annual sales volume in order to provide benchmarks on industry balance sheets, income statements and financial ratios. To use this data effectively, the appraiser figures out how the subject relates to the peer group norm, where it differs from the peer group and why it differs. The results should indicate whether the subject business is positioned better or worse than a typical business in the industry market place. A beer distributor may differ from its peer group norm in any number of ways such as having: a larger percentage of fixed assets (well maintained vehicles and equipment enabling it to provide exemplary service to retail driving routes); larger intangible assets (due to the acquisition of valuable distribution rights); higher profitability as a result of holding more popular brand rights in condensed urban areas or, conversely, lower profitability due to having a wide rural distribution territory or as a result of holding the rights to less popular brands.

> “*We generally use industry specific guidelines as an overall check for reasonableness. However, now and then, we incorporate a rule of thumb into our guideline method of the market approach to further support our analysis ...*”

Applying Rules of Thumb to the Subject Business

After the business appraiser has analyzed the overall industry and the traits specific to the subject business, it is a good idea to review the rules of thumb for businesses in the subject's industry. In practice, we generally use industry specific guidelines as an overall check for reasonableness. However, now and then, we incorporate a rule of thumb into our guideline method of the market approach to further support our analysis, especially when the rule of thumb is well established in the industry and is used by prospective buyers. According to the *2009 Business Reference Guide*, the price of a beer distributor is affected primarily by the brands carried and the distribution territory held. Two guidelines for estimating the value of a beer distribution business are summarized below:

RULE OF THUMB 1

$5 to $15 × number of cases sold over the last 12 months
+ hard assets
+ inventory
(multiple per case depends on popularity of brands sold)

RULE OF THUMB 2

Inventory at cost
+ rolling stock
+ any land & improvements included in sale
+ $1 × number of cases delivered per year
+ $1.5 × number of kegs delivered per year

Rules of thumb generally produce a range of value estimates depending upon the characteristics of a given business. Because each business is unique, the appraiser must judge whether the industry guidelines are applicable or not. In the following example we applied the previously described rules of thumb to calculate a value range for a hypothetical beer distributor. In this case we have narrowed the $5 to $15 range from Rule of Thumb 1 to $4 to $6 as this is more typical of the level we have seen in the marketplace.

In this example, the range of value estimates for the hypothetical beer distributor runs from a low of $2.1M to a high of $7.1M based on the per-case multiple used, with a much more narrow range of $5.1M to $7.1M using Rule of Thumb 1. As brand popularity is a driving factor in the case equivalent component of the value estimate, the value range for the hypothetical beer distributor (holding rights to brands with average popularity) can be narrowed toward the average value. It is also important to note that these rules of thumb are not sensitive to qualitative factors such as a level of distribution rights held that is higher or lower than the typical level or a distribution territory that is superior due to its condensed urban nature or inferior due to its wide rural nature. Since qualitative factors frequently have a material impact on value, the appraiser must make reasonable value adjustments to account for all relevant factors. Our example reinforces

> *"Rules of thumb generally produce a range of value estimates depending upon the characteristics of a given business."*

HYPOTHETICAL BEER DISTRIBUTOR
1,000,000 CE (case equivalents) sold
$500,000 trucks & trailers
$600,000 inventory held
No real estate held
Urban & rural territory, average size
Average brand popularity

APPLICATION OF *RULE OF THUMB 1
+ 1,000,000 CE × ($4 to $6)
+ $500,000 trucks & trailers
+ $600,000 inventory
Range:
$5.1M to $7.1M

APPLICATION OF *RULE OF THUMB 2
+ $600,000 inventory
+ $500,000 trucks & trailers
+ $0 land & improvements
+ $1 × 1,000,000 CE
+ $1.5 × 0 kegs
$2.1M

**These rules of thumb assume the business rents the property* the principle that there is more to valuing a business than simply plugging data into a general formula and selecting the dollar amount generated. Valuation professionals rely on a variety of methods, weighting each method based on its relevance to the given business enterprise, in order to arrive at a reasonable value.

Conclusion

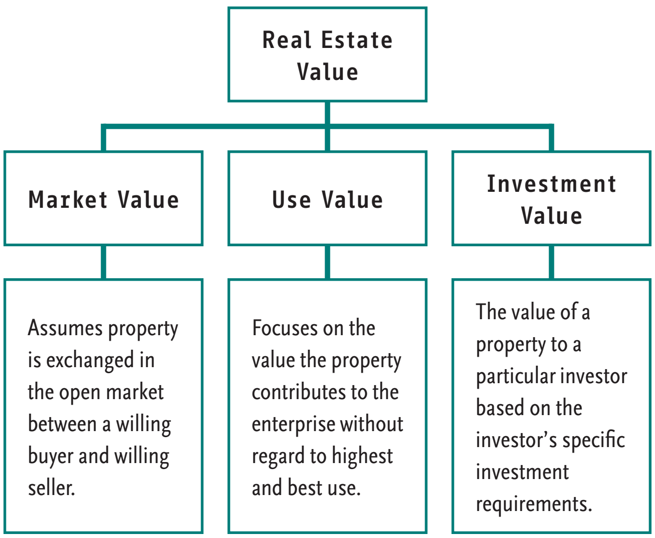
Rules of thumb are useful in the appraisal process as they provide a standard range of value within specific industries. Even if the subject business has unique aspects which set it apart from the peer group, it is important for an appraiser to be aware of the rules of thumb for similar businesses. If the appraiser understands and explains why the subject business does or does not fit within the standard range, the analysis is more likely to result in a defensible value conclusion. Rules of thumb are not a substitute for analyzing the subject business using the asset approach, income approach and market approach to value. They do, however, provide an overall check for the reasonableness of the value conclusion and may be used to further support the appraisal analysis.

"*Rules of thumb are not a substitute for analyzing the subject business using the asset approach, income approach and market approach to value.*"

continued from page 1

sional 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 use*,[2] 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 following chart illustrates three of the primary types of real estate value.



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. For other market participants, this is not the case. Perhaps the American Society of Appraisers[3] 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.

> *"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."*

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."

> *"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."*

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.

EXAMPLE PROPERTY ASSUMPTIONS	
Market Value of Property in Exchange	$4,000,000
Estimated Depreciated Value of Tenant Specific Improvements	$1,000,000
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

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	Use Value
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.

> *"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 of business enterprises as well as commercial real estate, Shenehon Company is uniquely positioned to solve valuation problems that involve both business and real estate components such those discussed in this article. VV

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.

MARKET TRANSACTION: BUSINESS VALUATION

ABC Wood Products, Inc.

123 Main Street
Outstate, MN

Our feature company is an old line Wood Products manufacturer. In 2006, we appraised the company for the purpose of management's buying out the old line shareholders. The company net revenues and adjusted EBITDA are shown in Figure 1.

FIGURE 1

YEAR	2001	2002	2003	2004	2005	2006	2007 EST.
NET REVENUE (IN MILLIONS)	12.8	11.4	10.0	11.7	12.9	14.0	13.8
EBITDA (ADJ)	1.0	.6	.3	.5	.8	.8	.7
% EBITDA	7.8%	5.3%	3.0%	4.2%	6.2%	5.4%	5.1%

The company has been a solid performer showing a slight growth in sales. The adjusted EBITDA ranged from a high of 7.8% to a low of 3.0% over the last 7 years, averaging 5.3% in the last four years. Additionally, the outlook for the next five years in the industry was strong. Management and stockholders could not agree on a price and decided to sell the company. Figure 2 summarizes the appraised value and offers.

FIGURE 2

	2006 APPRAISED VALUE	2008 JULY AND SEPT OFFERS	2009 APRIL PENDING OFFER
GROSS VALUE	$6,510,000	$10,000,000	$6,750,000
LESS PAYABLES NOT ASSUMED	0	0	$425,000
ESTIMATED LONG TERM DEBT	$2,100,000	$2,100,000	$2,100,000
NET VALUE	$4,410,000	$7,900,000	$4,225,000

Even though the values indicated above are approximates, the offers were firm and the transaction will close at the end of April, 2009. Nevertheless, the offers declined in value 53% in last nine months due to the current economic conditions. Assuming the company's fundamentals have not changed, it appears that the multiples of earnings and revenues in the marketplace have returned to historical rates. VV

MARKET TRANSACTION: REAL ESTATE

Property:	Stonehill Apartments 3501 Xenium Lane North Plymouth, Minnesota
Buyer:	Stonehill, LLC (Stuart Company)
Seller:	Stonehill Apartments (Ron Clark Construction)
Sale Date:	March 3, 2009
Sale Price:	$22,300,000
Unit Price:	$99,111
Gross Building Area:	366,529 square feet
Age:	1987
Land Size:	708,373 square feet, or 16.26 acres
Remarks:	This 225-unit Class B apartment complex included 230 underground parking stalls, social room, guest suite, fitness center, indoor and outdoor pools, sauna, whirlpool, and party room. Unit amenities include individual HVAC system, dishwasher, disposal, washer/dryer, fireplaces (select units), patio/balcony. The complex features studios (540 sq. ft.) with rents at $830; one bedroom units (781-893 sq. ft.) with rents at $895 to $950; two bedroom units (1,084-1,260 sq. ft.) with rents between $1,070 to $1,220; and two bedroom/den units (1,447sq. ft.) with rents at $1,345. At the time of sale, the property was 92% leased and the seller agreed to master lease three units at the average rent for the complex for a period of eight months. The capitalization rate was 6.25%.

SCOPE OF SERVICES

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.

Areas of Expertise:

- Allocation of purchase price
- Asset depreciation studies
- Bankruptcy proceedings
- Charitable donations
- Commercial properties
- Condemnation
- Contamination impact studies
- ESOP/ESOT
- Estate planning
- Feasibility analyses
- General and limited partnership interests
- Gift tax evaluations
- Going public or private
- Highest and best use studies
- Industrial properties
- Insurance indemnification
- Intangible asset valuation
- Internal management decisions
- Investment counseling
- Land development cost studies
- Lease and rental analyses
- Lost profit analyses
- Marriage dissolution
- Mortgage financing
- Multi-family residential properties
- Municipal redevelopment studies
- Potential sales and purchases
- Railroad right-of-ways
- Special assessment appeals
- Special purpose real estate
- Tax abatement proceedings
- Tax increment financing
- Utility and communication easements

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