Valuation Viewpoint
Shenehon Company
www.shenehon.com
Volume 19, Number 1 Winter 2014

When Value Matters

Does Your Client Need a Business Valuation, a Real Estate Appraisal, or Both?

By Robert J. Strachota, MAI, CRE®, MCBA, FIBA

Introduction

Sooner or later, almost everyone is required to provide an estimate of value for his or her assets. Whether it is for income tax purposes, estate tax purposes, financing purposes, etc., you will need the services of an appraiser. Value is an economic concept based on the cost of procuring something now for benefits in the future. In simpler terms, it is what the buyer is willing to pay the seller for an asset in today's market. However, there are many types of value. Among them are: fair market value, fair value, market value in use, investment value, market value, and liquidation value. Business valuation and real estate valuation are two different disciplines. Although the processes of arriving at a value and the terminology seem similar, the two are not interchangeable. Based on the nature of the assignment, an experienced valuation professional will identify the standard of value, the type of appraisal necessary, and the most appropriate methodologies to use.

As an industry, the appraisal profession is fairly young. Real estate valuation, which is based on personal property ownership rights as described in economic theory from the 18th and 19th centuries, predates business valuation. Business valuation became popular in the 1920s following enactment

continued on page 3

Market Trends and Indicators

Office Buildings–Downtown	↑	4%
Office Buildings–Suburban	→	0%
Retail Centers	↑	2%
Industrial Buildings	↑	2%
Apartments	↑	4%
New Housing Starts–Midwest	↑	17.5%
Productivity	↓	.3%
Composite PE	↑	23.8
US Unemployment	↓	6.7%
Consumer Confidence Index	↓	78.1

In This Issue …

MARKET TRENDS AND INDICATORS

ECONOMIC INDICATOR

	2007	2008	2009	2010	2011	2012	2013
New Housing Starts—Midwest Yearly Totals	211,700	137,700	97,600	99,400	102,700	132,000	155,200(p)

P/E RATIOS IN SELECT INDUSTRIES

Industry (Year End)	2007	2008	2009	2010	2011	2012	2013
Basic Materials	14.1	15.2	21.6	27.4	19.7	12.6	20.0
Conglomerates	18.4	15.8	10.7	15.0	16.9	15.2	15.1
Consumer Goods	24.4	16.3	15.9	24.9	21.1	20.1	22.1
Financials	13.7	11.7	9.6	36.2	17.9	12.5	14.9
Healthcare	40.0	26.0	57.7	26.1	18.9	21.5	27.4
Industrial Goods	19.5	19.5	20.3	23.5	17.9	13.3	27.0
Services	28.7	24.2	20.1	26.6	27.1	20.1	27.5
Technology	38.4	23.8	16.4	45.2	20.2	18.1	30.9
Utilities	20.0	15.3	12.0	28.5	16.2	15.5	29.5
Composite	**24.0**	**18.7**	**20.5**	**28.2**	**19.5**	**16.5**	**23.8**

ECONOMIC INDICATORS

Indicator (5 yr. avg.)	2005	2010	2011	2012	May 2013	2013
Inflation	3.4%	1.6%	3.1%	2.1%	1.2%	1.5%
Productivity	1.8%	1.5%	0.8%	1.9%	0.5%	0.9%
GDP	3.1%	3.0%	1.7%	2.2%	1.8%	2.5%
Consumer Confidence	107.2	62.0	70.8	72.2	81.4	78.1

UNEMPLOYMENT

	1990	1995	2000	2005	2010	2011	2012	Dec 2013
US	**5.4%**	**5.6%**	**4.0%**	**5.3%**	**9.4%**	**8.5%**	**7.8%**	**6.7%**
Northeast	5.0%	6.0%	4.0%	4.9%	8.4%	8.0%	8.1%	7.3%
Midwest	5.7%	4.5%	3.5%	5.7%	8.7%	7.9%	7.2%	6.9%
South	5.4%	5.4%	4.0%	5.2%	9.3%	8.4%	7.3%	6.7%
West	5.1%	6.6%	4.6%	5.5%	11.0%	8.5%	8.6%	7.6%
Minnesota	**4.6%**	**3.6%**	**2.9%**	**4.5%**	**7.0%**	**5.7%**	**5.4%**	**4.6%**

RATES OF RETURN AND RISK HIERARCHY

Investment		Investment	
30 Year Treasury	3.9%	S & P Equity (Ibbotson)	10.6%
Aaa Bond	4.5%	Equipment Finance Rates	10.0–12.0%
Bbb Bond	5.06%	Speculative Real Estate	11.0–16.0%
Commercial Mortgage	5.0–6.0%	NYSE/OTC Equity (Ibbotson)	14.4%
Institutional Real Estate	5.75–7.0%	Land Development	15.0–30.0%
Non-Institutional Real Estate	8.0–10.0%	NYSE Sm Cap. Equity (Ibbotson)	22.25%

Sources: Appraisal Institute, Business Week, Value Line, U.S. Chamber of Commerce, Standard & Poors, Investment Dealers Digest, U.S. Government Census, Yahoo Finance, Bureau of Labor Statistics, Ibbotson Associates, and PwC Real Estate Investor Survey.

of the 18th Amendment to the Constitution, better known as Prohibition. As a result of prohibition laws, many companies selling alcohol were forced to close their doors overnight. The U.S. Government stepped in and granted these companies tax breaks or compensated them for lost sales and profits. Up to this time, business value was assumed to be equity (assets minus liabilities). Modern business valuation theory starts with the premise that the value of a company is measured by its goodwill and its ability to generate cash flow. Goodwill may be comprised of different components such as a trained work force, customer base, trade names, and reputation in the community. If one understands the similarities and differences between real estate valuation and business valuation, it is much easier to decide whether you need a business appraisal, a real estate appraisal, or both.

> *"Business valuation and real estate valuation are two different disciplines."*

The bundle of rights is a common way to explain the complexities of property ownership. The term came into use in the late 1800s and is used to illustrate how a property can be owned by multiple parties at the same time. Ownership of land involves more than simply acquiring all the rights to it; one might envision a bundle of firewood where each stick in the bundle represents a single right. The property owner possesses a set of rights directly related to the land which can be separated and re-packaged.

As discussed, the concept of real estate as a valued asset has been around for hundreds of years, whereas valuing businesses is relatively new. The bundle of rights analogy provides an excellent platform from which to study valuation questions. Overall ownership interests are represented by a bundle of sticks, with each individual stick standing for a distinct right or interest. As with most value concepts, the idea of valuing a bundle of rights, which was

REAL ESTATE BUNDLE OF RIGHTS

Development	Mineral	View
Water	Forage	Preservation
Easement	Air	Access

BUSINESS INTANGIBLE VALUE BUNDLE OF RIGHTS

Brand Name
Patents
Copyrights
Trademarks
Skilled Workforce
Goodwill
Product Design
Customer List

originally used to describe real estate ownership situations, has now been extended to business valuation. But, one must keep in mind the bundle of rights for real property is different from the bundle of rights for business enterprises. While the term bundle is the same, the sticks in the bundle differ for business valuation and real estate valuation.

Historically, the value of a business was the sum of its real estate, machinery, and equipment, less its liabilities. Value in the market did not rise to a level which included value for intangibles such as a concept: brand, value for patents, copyrights, etc., until after World War II. The chart below shows the growth of intangibles (gray line) in business valuation relative to tangibles assets (black line). This is the birth of business valuation as a separate practice or discipline within the valuation profession.

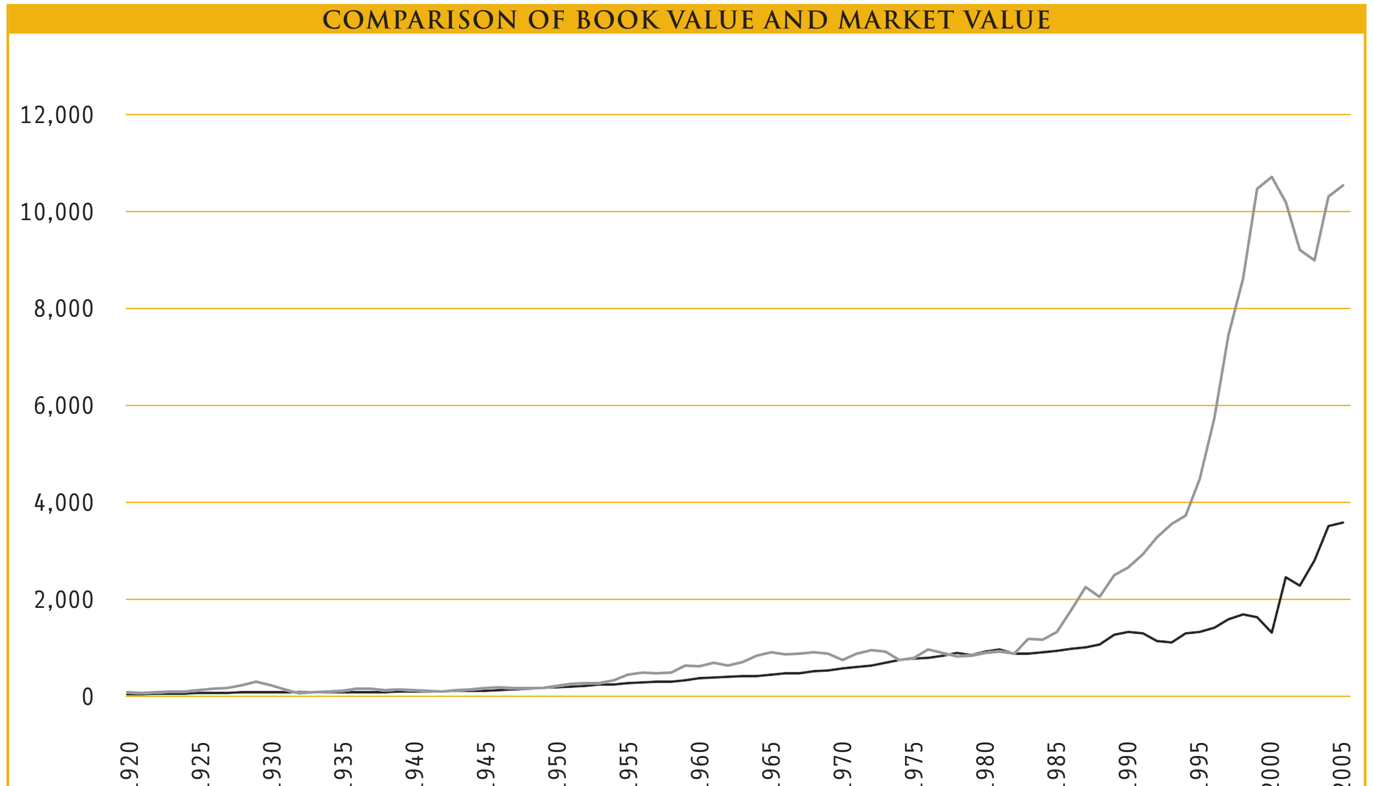
> *"For appraisal purposes, real estate value is typically based on the land, building, and site improvements and their ability to be sold for money"*

Overview of a Real Estate Valuation

Real estate and real property are not the same. According to The Appraisal of Real Estate (13th Edition), real estate includes the physical land and anything fixed to the land, above or below ground. It is tangible and immovable. Real Property encompasses all interests, benefits, and rights which come with physical ownership of the land. Real estate title generally includes title to air rights, mineral rights, and surface rights which can be bought, leased, sold, or transferred together or separately.

For appraisal purposes, real estate value is typically based on the land, building, and site improvements and their ability to be sold for money. Real estate value does not concern itself with what the business that occupies the real estate earns; rather it considers only what that real estate could be sold for based on its rental income or value in trade (the price at which comparable real estate is selling for at the time).

COMPARISON OF BOOK VALUE AND MARKET VALUE



A real estate appraisal is typically required if the subject business:

- Is a residential or commercial property, such as a single-family residence, apartment, industrial, or office building;
- Is a whole or partial interest in real estate, such as tenant in common or joint tenancy;
- Engages in an activity whose primary value component is the location of the real estate;
- Has a value that fluctuates primarily with the real estate market;
- Derives revenues from the use or leasing of real estate;
- Uses real estate as its primary asset;
- Has real estate assets that cannot be moved;
- Has primarily tangible real estate assets that produce economic activity in the form of lease revenue; or
- Has real estate-related operating expenses, such as property management and maintenance.

Overview of a Business Valuation

Business value is defined as the entire value of a business: the summation of all its parts, tangible (real estate) and intangible (enterprise value). Intangible assets include goodwill, trained workforce, and patents. Real estate is considered part of an entity's overall business value. When forming an opinion of value, the appraiser calculates the value of the intangible assets and adds the value of the tangible assets to arrive at the business value. A business valuation will typically be required if the subject business:

- Derives revenues from producing goods and services, and it rents its facility from an unrelated third party;
- Engages in an economic activity in which the location of the economic activity's real estate is often not a key factor;
- Has a value that depends more on industry conditions than on real estate market fluctuations;
- Uses primarily machinery, equipment, employee skills, or other assets (rather than real estate) in generating goods and services;
- Uses intangible assets such as patents, trademarks, copyrights, and customer lists to generate earnings;
- Is a commercial, industrial, or service organization engaged in an activity other than the sole operation of real estate;
- Is an equity, fractional or minority interest, or is difficult to split up because the owners do not have a direct claim on the assets; or
- Has substantial assets that can be moved from one location to another.

Organizing the Value Components

The following equation gives us a way to organize multiple components in a business valuation:

TANGIBLE ASSETS

- Real estate
- Machinery
- Equipment
- Tenant improvements
- Mineral rights

+

INTANGIBLE ASSETS

- Patents
- Brand
- Trained workforce
- Goodwill
- Customer lists

=

BUSINESS VALUE

Market Value

Both real estate and business appraisers are looking for the market value of the subject. However, market value means something different to each. Market value for real estate purposes is defined in *The Dictionary of Real Estate Appraisal*, Fifth Edition, page 122, as:

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

Real estate is, by its very nature, the king of illiquid investments. A reasonable exposure time for converting the asset value to cash is important. When a real estate appraiser values a property, he or she must determine a reasonable marketing time. Depending on the type of property, a reasonable marketing time could range from a few weeks to ten years or more. Real estate assets, because of their permanent nature, are heavily dependent on a number of factors, including things like location, economic outlook, and market trends. It is up to the real estate appraiser to determine a reasonable marketing time, and if a client requests a valuation based on something shorter, that will affect the value.

> *Business value is defined as the entire value of a business: the summation of all its parts, tangible (real estate) and intangible (enterprise value).*

USPAP sets forth guidelines for the real estate appraiser to follow if a shorter than normal marketing time is assumed in developing the value.

Market value for business valuation appraisers is slightly different. The business valuation definition in Section 2 of Revenue Ruling 59-60 states the definition of fair market value as follows:

> *The amount at which the property will change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts.*

There is no mention of timing or a definition of reasonable market time, because business appraisers approach market value from a different point of view, often determining the value of a company as if it were to be sold the very next day.

Framework for Analysis

Business appraisers and real estate appraisers rely on a similar framework to guide the appraisal process.

Economic analysis: for business appraisers, this means understanding the economy that the company is operating in and how it may influence the company's future outlook. This could include information about interest rates, demographic trends, and historical data. For real estate appraisers, information about the location, neighborhood, and traffic patterns surrounding the property come into play.

Industry analysis: focuses on the particular industry a company operates in. Understanding trends, conditions, and other factors are important in weighing historical data against future projections. Real estate properties have their own industry analysis, which might include things like collecting data on retail sales to aid in determining the value of a commercial property.

Company analysis: delves deeply into the nuances of the company's particular attributes and history. Its customer base, the nature of its products and services, and other qualitative aspects inform this part of the analysis, and help to flesh out the narrative. For real estate appraisers, this might include detailed data that is unique to the property – its size, the year it was built, its physical condition. These particulars are important in illustrating the distinctions in value when building a valuation case.

Financial performance and volatility: provide essential insight into what an investor might reasonably expect from future performance; offers an overview of the company's risk profile. The key to a thorough valuation though, is to not just compute various ratios and financial gauges but to actually use them to assess the company's risk. This part of the process is highly integrated with other parts of the valuation, particularly the industry and company analyses. A valuation report should convey to the user of the report how and why a company's financial results and financial position influence the company's risk. Real estate appraisers might look at rent logs and create surveys of rent comparables to help inform the larger overall profile of a property.

Approaches to Value

There are three traditional approaches used when valuing an interest in a closely-held entity (business) or a real estate asset. Within each approach, there are various methods and techniques that are typically employed. The three valuation approaches are:

- Income Approach: involves the conversion of expected future cash flow into a present value;
- Market Approach: determines value by comparison with transactions in similar businesses or business interests; and
- Asset Approach: incorporates the valuation of all the company's assets and liabilities (the asset values are totaled and the liabilities subtracted to determine an adjusted net equity value of the business).

> *Both real estate and business appraisers are looking for the market value of the subject. However, market value means something different to each.*

In both real estate and business valuation, the last step is a synthesis of the approaches and conclusion of value. Weight may be distributed to the method the appraiser feels is most applicable, and the final value must be assessed as "reasonable."

Apportioning Real Estate and Business Value

In many cases, the value of a business is intricately intertwined with that of its underlying real estate assets. The business and real estate components of value are especially interconnected if the real estate is a special-use property and a major asset of the business. Convenience stores and gas stations, hotels, casinos, lube centers, auto dealerships, car washes, bowling alleys, marinas, cemeteries, theaters, restaurants, and mobile home parks are just a few of the many types of businesses that rely heavily on their underlying real estate assets.

In these situations, a business valuation methodology that generates stand-alone business and real estate appraisals may prove beneficial and provide a more accurate assessment of total value. Real estate valuation methodologies have been designed to generate stand-alone realty value conclusions. In other words, the real estate appraisal values the property assuming an unrelated tenant. Similarly, business valuations typically assume a hypothetical buyer of the business and must, therefore, also assume that the real property utilized by the business is leased from an independent third party. Overlap between realty and business will occur whenever the subject company's operations and the realty used by that enterprise are owned by the same party.

The key to effectively apportioning real estate value and business value is the imputation of a fair market rent associated with the real property of the business. This imputed rent, which serves as a reduction of cash flows for purposes of generating a business value, is also the basis for determining realty value. Determining separate, stand-alone real estate and business values through this method will usually result in a more meaningful value conclusion. Thus, the appraisal can determine how effectively management is utilizing the underlying real estate assets to generate additional business value. Additionally, separate appraisals of the real estate and the business may reveal the real property assets are not being utilized to their highest and best use.

Both Real Estate and Business Appraisals

The specifics of each situation dictate whether a business valuation, a real estate appraisal, or both will be performed. In certain cases, a credible and defensible valuation requires the advice of both a business valuator and a real estate appraiser. Now that we understand the basic framework business and real estate appraisers use to determine value, let's address a situation in which a client may require the expertise of both types of appraisers. The following scenario illustrates the typical manner in which the two work together. A company requires a valuation. It owns several restaurants along with the underlying real estate. The real estate appraiser, relying on market research and professional judgment, will establish a fair market rent. The fair market rent is used by the real estate appraiser as a method to value the real estate. The business valuator adjusts the restaurant's cash flows upward or downward by using the fair market rent determined by the real estate appraiser. The result of imputing the market rent is to adjust the cash flows generated from the business, which affects the business value. However, the business value is ultimately combined with the real estate value to determine the total enterprise value of the company.

> *In many cases, the value of a business is intricately intertwined with that of its underlying real estate assets.*

Valuation Synthesis and Conclusion

For both real estate appraisals and business valuations, when it comes time to conclude a value, the appraisers consider the values indicated from each valuation approach and weigh the relative merits of each approach in light of the facts and circumstances surrounding the subject. One primary advantage of using multiple approaches is that it forces the appraisers to reconcile values from the individual approaches before concluding a final value. The reconciliation process allows the valuation specialist to revisit the assumptions and judgment calls made during the valuation process. During the final review, the appraiser has the opportunity to become comfortable with the applicability of each method and is in a better position to weight each method appropriately.

Often labeled the "fourth approach" to value, the final step in the valuation process is the "reasonableness check." The value conclusion should always be assessed on the basis of whether it is reasonable. To address reasonableness, the appraiser has many financial tools for conducting a verification analysis. These analyses are not the same for real estate and business valuation.

> *The specifics of each situation dictate whether a business valuation, a real estate appraisal, or both will be performed.*

With regard to real estate, the appraiser can test the likelihood of the value conclusion in a number of ways. For example, the appraised value of a large land parcel near the edge of a city could be tested by using land development principles to determine if a developer would realize a profit developing a bulk parcel. If the appraiser is valuing a shopping center, a good reasonableness test might be whether the projected cash flow will cover a 60-70% mortgage payment which is how most buyers would purchase the property. Or, for a new apartment building, does the projected cash flow drive a value that is substantially greater than what it would cost to build a new structure?

With regard to business enterprises, the appraiser tests the market value of the business by studying the stand-alone values of all the components to see if the total of the stand-alone values is greater than the business value. If so, the business should be closed and the assets sold off. Or, the appraiser could test the feasibility of the value conclusion against loan terms available at major banks for the acquisition of the company. Lastly, the appraiser could test the implied intangible values against industry multiples and trends.

Armed with a general understanding of the essential analyses which comprise a defensible real estate or business valuation, all stakeholders in the valuation process can appreciate the folly of unduly simplifying or narrowing the scope of work to be performed. To do so will likely produce results that lack sensibility.

Final Value Reporting for Real Estate and Businesses

A letter of transmittal is typically used for both real estate appraisal and business valuation, and the conclusion of value is reported by the appraiser in this letter. However, the type of value reported by the real estate appraiser and the business valuator is markedly different. Real estate values are reported on a gross basis ignoring debt, while business values are reported on a net basis taking debt into account. Both business and real estate appraisers call their conclusions market value, but the values are clearly different.

This brief overview indicates the importance of recognizing what type of valuation is required. It is critical to understand the differences between business valuation and real estate valuation. It bears repeating: although the two disciplines use many of the same words, they mean very different things depending on whether you are valuing real estate or a business. VV

REAL ESTATE AND BUSINESS TRANSACTION

Property:	Minnesota Masonic Homes – North Ridge
Buyer:	New Hope Property, LLC
Seller:	Minnesota Masonic Home North Ridge
Sale Date:	November 14, 2013
Sale Price:	$39,027,981
Price per square foot:	$83.39
Gross Building Area:	353,852 square feet
Zoning:	R-4/R-5: Multiple Family – supervised residency allowed
Age:	1969/1983
Land Size:	570,636 square feet/13.1 acres
Commentary:	Over the last few years, the marketplace has been flooded with senior apartments offering menus of supplemental services. Services may include skilled nursing care, memory care, and food service; all of which are billed in addition to apartment rental fees. Transactions involving these types of facilities are often considered real estate transactions. In reality however, if one considers the operational components and the goal of making a profit, these are business and real estate transactions. New Hope Property, LLC, an affiliate of Aviv real estate investment trust, purchased the subject property and subsequently brought in a management group to operate the business.

The purchase price included the potential profit from seniors paying for additional services. It appears this facility sold with a cap rate between 11.0-12.0%, including FF&E and before any capital expenditures. When valuing this type of property, the appraiser normally calculates a separate deduction for capital improvements. The risks of owning a facility such as the subject are greater than the risks associated with ownership of typical investment real estate.

A strong management team is required to ensure the many components of the business run smoothly, efficiently, and in compliance with regulations. The skills required to successfully operate a profitable facility are not readily available in the marketplace.

SHENEHON
BUSINESS & REAL ESTATE VALUATION

88 South Tenth Street
Minneapolis, Minnesota 55403
612.333.6533
Fax: 612.344.1635
e-mail: value@shenehon.com
www.shenehon.com

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

Contributors:
William Herber, Denise O'Leary, John Schmick, Robert Strachota, and Scot Torkelson