VALUATION VIEWPOINT

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Personal Goodwill

By Jackson W. Wiberg

The distinction between personal and enterprise goodwill is an important concept in business valuation, particularly when valuing closely held businesses for legal purposes. The International Valuation Glossary – Business Valuation defines goodwill as "an intangible asset which represents any future economic benefit arising from a business or group of assets which is not individually identified or separately recognized. Goodwill can arise as result of name, reputation, customer loyalty, location, products, and similar factors not separately indentified." There are two types of goodwill: enterprise and personal. Enterprise goodwill is associated with the business itself and arises from factors such as an established brand, trained workforce, and operating systems. This type of goodwill is considred transferable, meaning it would likely remain with the business even if the ownership changes. Personal goodwill, by contrast, is tied directly to an individual's reputation, relationship, skills, and continued involvement. The extent to which personal goodwill is transferable is dependent on the continued presence and efforts of the specific individual.

This distinction plays a critical role in business valuation because it affects how future income streams are interpreted. If all goodwill is treated as enterprise goodwill, a valuaton may overstate the value of the business by assuming that earnings will continue unchanged regardless of who owns or operates it. In reality, many closely held businesses depend heavily on the personal efforts of the owner, particularly in professional practices or service-based industries.

The distinction becomes especially significant in the context of marital dissolution, as courts must determine what constitutes marital property subject to division, and the treatment of goodwill can substantially affect the outcome. Because the full value stemming from personal goodwill can only be realized through post-marital efforts from the owner-spouse, personal goodwill is treated as a non-marital asset in most states including Minnesota. Minnesota courts treat enterprise goodwill as a divisible marital asset while recognizing that personal goodwill is inseparable from the individual and therefore not subject to equitable distribution.

Beyond divorce, the distinction between personal and enterprise goodwill is also relevant in other contexts. In business sales, buyers are typically unwilling to pay for personal goodwill unless steps are taken to ensure that the seller will continue to contribute to the business or refrain from competing. This often leads to the use of employment agreements or non-compete clauses to convert personal goodwill into a more transferable form.

In this issue:

Personal Goodwill

Continued from page 1

The process of excluding personal goodwill in a valuation involves a detailed analysis. The valuation expert must consider whether clients are loyal to the business or to the individual, whether there are employment or non-compete agreements in place, and whether the business has independent branding or systems that would allow it to continue operating successfully without the owner. The level of transferable goodwill is then reflected in the forecasted performance of the business, taking into account the expected level of involvement of the key individual after the valuation date. It is also incorporated into the company's risk profile, as refelcted in the estimated discount rate and the selection of appropriate valuation multiples. The existence of a key person within a business generally increases risk, as any interruption in their involvement could substantially hinder operations.

Distinguishing between personal and enterprise goodwill is essential to producing a credible business valuation, particularly in closely held business where the owner's role is central to operations. While the distinction is more clearly defined in marital dissolultions due to established case law, it remains important in the valuation of any business involving a key individual, as it warrants a thorough analysis of risk and performance based on that individual's level of continued involvement.

Ground Leases: What They are, When They are Useful, and Best Practices for Structuring a Ground Lease

By Ryan E. Flynn

Ground leases are unique real estate transactions that can offer advantages and disadvantages to both landlords and tenants. Although ground leases, also referred to as land leases, are common in certain situations, they are often misunderstood by the wider community.

A ground lease is a lease of unimproved land between the owner of the property and a tenant. They often span a long-term, typically 50 to 99 years, and allow a tenant to develop and build structures on the land while paying rent and other expenses over the term of the lease. Tenants are responsible for the construction of the new improvements at their sole cost and expense. Unless otherwise negotiated, at the end of the lease term the site improvements revert to the landowner. Ground leases are often used at well-located land sites that otherwise could not be purchased.

Although this lease structure may initially seem disadvantageous to the tenant, there are many situations where a ground lease is beneficial to both the tenant and landowner. When Ground Leases are Beneficial

From a tenant's perspective, the greatest positives of a ground lease are frequently captured at the beginning of the term. Ground leases allow tenants to develop a site, often at a premium location, without the upfront capital expenditure of acquiring the land. This is why ground leases are often used by many big retail tenants such as McDonald's and Walgreens. Ground leases can also offer tenants access to sites that would not otherwise be available for purchase such as federal land. Further, ground leases offer enants significantly reduced rents

Ground Leases: What They are, When They are Useful, and Best Practices for Structuring a Ground Lease

Continued from page 2

when compared to leasing a similar site with existing improvements. Other advantages for tenants include the tax benefits of depreciating improvements and long-term stability with rental rates.

From a landlord's perspective, ground leases can offer long-term stable rental income with minimal capital investment. Landowners typically prefer creditworthy tenants when entering into a ground lease as they are viewed as a long-term investment. These agreements allow landowners to keep long term ownership of a property while still monetizing the site. Ground leases are often negotiated so that the site improvements are inherited by the landowner upon lease expiration, which can increase the value of the property for the landlord at the end of the term. Ground leases can also be used by landowners to direct the type of development at a property. Landowners who wish to see a certain type of development at a site but lack the professional expertise to execute such a development can use a ground lease with specific terms to direct the development of a site. A good example of this type of ground lease is a municipality entering into a ground lease with an affordable housing developer.

However, ground leases are not without their disadvantages. For tenants, the costs of constructing the site improvements can be substantial and they are solely responsible for property taxes, insurance and maintenance. Additionally, the loss of the rights to the improvements at the end of the term can have tenants paying significantly higher rents following a ground lease expiration if they wish to continue using the site. For landlords, the rents of ground leases are significantly lower compared to land and building rents. Additionally, if not negotiated correctly, the long lease terms of ground leases can lead to rents significantly below market rates near the end of the lease term. A full matrix outlining the advantages and disadvantages of ground leases for tenant and landlord follows.

	Pros	Cons
Tentant Perspective	• Avoid upfront capital expidenture of purchsing land and avoid capital gains tax upon sale of land • Tax benefits associated with depreciation of site improvemts • Reduced lease payments compared to leasing both land and buildings • Long-term lease with stable rental rates • Access to sires that don't allow owner to sell the property but will allow a ground lease (ex: Federal Lands)	• Responsible for paying for or financing construction of improvements • Solely responsible for property taxes, insurance, and property maintenance • Long term commitment • Forfeit improvements to landlord at end of lease term
Landlord Perspective	• Monetize real estate without significant capiral investment • Long-term stable income with minimal risk • Retaining ownership of a property • Can offer some control over the type of development at a property • Inherit property improvements at lease expiration	• Ground rents are lower when compared to land and building rents • Long lease terms can lead to below market rent near end of lease term • Site improvement may be at the end of their useful life when the lease expires • Loss of land use for extended period

“Without proper rent escalations, a ground lease risks becoming unequal to one party over the course of the lease term.”

Ground Leases: What They are, When They are Useful, and Best Practices for Structuring a Ground Lease

Continued from page 3

Best practices for structuring a ground lease

When the advantages for a ground lease align with both tenant and landlord interests, it is important that the ground lease is structured to be fair for both parties. There are several important aspects to consider when negotiating a ground lease. They are the market value of the land, ground rent capitalization rate, lease term and renewal options, rent escalations, and future recalculations of market rent.

Market Value of Land

The rent of a ground lease is most often based on the market value of the vacant land. This value of the land as vacant can be based on the highest and best of the land, or it can be based on a proposed development project that a ground lease is facilitating. Sales comparison is usually the preferred method for developing a land value opinion, but in situations where not enough sales of similar properties are available, alternative methods may be used. For land values that are based on a proposed development project, it is important that land sales for similar projects are used when reconciling the market value of the land.

Ground Rent Capitalization Rate

Once the market value of the land is determined the next step is to select an appropriate yield rate to determine the ground rental rate. Rates for ground leases can generally range from 5.0% to 10.0% of market value depending on several factors with location playing a significant role. For example, ground leases for land in major urban downtown areas or high visibility commercial areas tend to fall toward the low end of the range and inversely ground leases for tertiary markets or underdeveloped areas will fall toward the upper end of the range. In this example, sites with strong locations are considered less risky and will require a lower rate of return from the landowner. Additionally, the value associated with the strong location of these sites will be captured in the market value of the land. The inverse is true for sites in tertiary markets.

Lease Term

Most ground leases are under contract for periods of at least 15 years and often range in length from 50 to 99 years. Short term ground leases are more typical for retail-oriented properties that are leased by credit-worthy national tenants. Most ground leases are structured to be 99-years in length, which gives the grantee the security of a long-term lease. Long-term leases are also important for lending purposes because lenders are often unwillingly to finance real estate improvements that are on a short-term ground lease. As a simple example, if the borrower is seeking a 30-year mortgage but only 25 years remain on the ground lease, lenders might be unwilling to finance such a deal. Renewal or purchase options are also commonly found in ground leases, which allow the grantee the opportunity to extend the lease or purchase the land with terms negotiated based on market value.

Rent Escalations and Recalculations

Once an initial rent and lease term is set, it is important to negotiate rent escalations and recalculations to ensure that the ground lease stays in line with market conditions throughout its term. Without proper rent escalations, a ground lease risks becoming unequal to one party over the course of the lease term.

Ground Leases: What They are, When They are Useful, and Best Practices for Structuring a Ground Lease

Continued from page 4

Rent escalations are common in all types of real estate and the two most common types are annual escalations or periodic step rent adjustments.

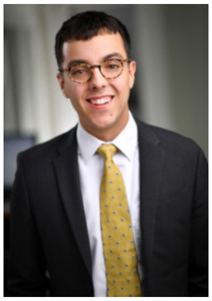
Annual escalations are more common in short-term leases and allow for annual adjustments in rent. For long term ground leases, periodic step-up rents tend to be more common but annual escalations are also utilized. A step-up rent adjusts rent incrementally, most commonly every five to ten years. It can either be based on a fixed adjustment, such as a 10% increase every ten years, or tied to an index or benchmark like CPI (rent will increase based on the change in the index from the last rent escalation). We would also note that most leases that are tied to an index or other financial benchmark have a clause that prevents the rent from decreasing from the previous rental rate.

Lastly, it is recommended that long-term ground leases provide for periodic recalculations of market rent. These recalculations typically can be made every 20 to 30 years to help prevent the lease from falling significantly out of line with the market as time goes by and predetermined rent escalations may become less reliable. Recalculations are recommended at longer time intervals as the process involves renegotiating the lease between the grantor and grantee and when the two sides cannot come to an agreement it oftencan involve attorneys and appraisers and a prolonged and potentially expensive negotiation period to establish the new rate.

Conclusion

Ground leases are a useful tool in a variety of situations. They offer long term-stability and unique benefits to both tenants and landlords. It is important that the terms of a ground lease consider the interests of both parties and allow for rents to align with the market. When the interests of a tenant and landlord align, a ground lease can be beneficial for all parties involved.

Meet The Authors



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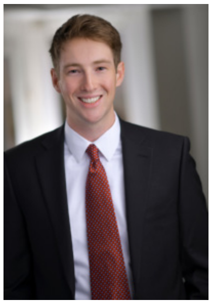
Jack is a business valuation analyst at Shenehon Company. As an analyst, he prepares analyses in valuations of both operating and holding companies. Jack graduated from the University of Minnesota, Carlson School of Management with a degree in Finance and a Minor in Business Analytics. During his last two years of schooling, he worked at the University's Office of Information Technology as a Finance Support Assistant. There, he gained valuable accounting experience through inventory management, payroll updating, and journal entries. Jack's previous internship experience was with The Toro Company where he created a back-end database containing prices and current costs for thousands of products in pursuit of accurate margin analysis.



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Ryan is a real estate valuation analyst at Shenehon Company. As a valuation analyst, he studies the performance and sales of markets to provide insight to clients on the fair market value of their property. Previously, Ryan worked as a lease administration analyst at Jones Lang LaSalle, focusing on their UnitedHealth Group account. He graduated from the University of Nebraska with bachelor degrees in finance and mathematics.

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