Enterprise Component Allocation: Methodology Discussion

BY ROLAND D. NELSON, CRE

Editor's Note: *Roland D. Nelson, a CRE for 30 years, passed away in March 2009.*

BUSINESS ENTERPRISE VALUE (BEV) HAS FOR MANY YEARS eluded a universally accepted method of appraisal. It has been the subject of much discussion, writing and even litigation. By definition intangible, BEV is difficult to pin down. This article reviews various methodologies for estimating BEV, and discusses how it relates to various types of real estate.

Business enterprise value is a component of going-concern value, which is defined in *The Dictionary of Real Estate Appraisal, Fourth Edition,* as:

1. The market value of all the tangible and intangible assets of an established and operating business with an indefinite life, as if sold in aggregate; also called *value of the going concern*;
2. Tangible and intangible elements of value in a business enterprise resulting from factors such as having a trained work force, an operational plant, and the necessary licenses, systems, and procedures in place;
3. The value of an operating business enterprise. Goodwill may be separately measured but is an integral component of going-concern value.

Going-concern value was originally defined by the United States Supreme Court in a 1933 case involving a public utility (Los Angeles Gas & Elec. Corp. v. Railroad Com'n, 289 U.S. 287), as follows: "This court has declared it to be self evident that there is an element of value in an assembled and established plant, doing business and earning money, over one not thus advanced, and that this element of value is a property right which should be considered in determining the value of the property on which the owner has a right to make a fair return."

A counselor or appraiser may be requested to isolate the BEV, which is defined in *The Dictionary of Real Estate Appraisal, Fourth Edition,* as follows: "A term applied to the concept of the value contribution of the total intangible assets of a continuing business enterprise such as marketing and management skill, an assembled work force, working capital, trade names, franchises, patents, trademarks, contracts, leases, and operating agreements." Reasons to separate BEV components of a going concern include: 1) benefits to the ownership of the after-income-tax cash flow; 2) property tax purposes; 3) mortgage lending allocations; and 4) general property analysis. Identifiable real estate entities that have basic earmarks of enterprise components include: restaurants, gasoline service stations, hotels, marinas, shopping centers, bowling alleys and nursing homes.

About the Author

Roland D. Nelson, CRE, *began his career in the real estate valuation business in 1953, and until his death in March, served as a director with Integra Realty Resources in Detroit. As a writer, Nelson had numerous articles published. A Counselor of Real Estate for 30 years, Nelson also was a member of the Appraisal Institute; the Real Estate Answer Forum; the Institute of Real Estate Management; and the National Association of REALTORS®.*

Real property is sometimes valued and subtracted from the going-concern value to isolate the BEV. Conversely, one can value each non-real estate component, separate these items from the value of the going concern, and thus isolate the value of the real estate. Also, BEV components could be identified by employing a discounted cash flow (DCF) analysis. The difference between the value of the property as currently in operation and the same property if vacant and available could well be the business enterprise value.

In any type of analysis, the appraiser should first research the market for items that are the easiest to identify and isolate. By elimination, the components of the BEV can be narrowed down to the more difficult items to value.

Generally, when the market declines on volatile, relatively short-lived enterprises, the last item of value remaining is the BEV, including licenses, operational expertise, supplies, etc. An operation that no longer supports the land and/or improvements will finally be closed, at which time the highest and best use of the real estate is greater than the current non-performing use; hence there is no BEV.

This author is in general agreement with most articles and valuation analyses regarding valuations of BEV, but concludes that there are no perfect or superior methods. Appraisers have spent considerable time and effort on various thoughts and methods, and most agree that more than one method can be applicable.

There is another component of real estate enterprise and BEV that needs to be defined, that being goodwill, defined in *The Dictionary of Real Estate Appraisal, Fourth Edition* as:

1. An intangible asset category usually composed of elements such as name or franchise reputation, customer patronage, location, products and similar factors;
2. The intangible asset that arises as the result of name, customer patronage, location, products, and similar factors that have not been separately identified or valued but that generate economic benefits.

Under IRS Section 197, goodwill is to be amortized over a 15-year period for income tax purposes.

The aim of many investors is to seek "tax shelters" in real estate-oriented properties for after-tax cash flow returns. Historically (prior to 1992), when enterprises were sold, the general tendency was to minimize land value, allocate everything possible to depreciable tangible improvements, and ignore business value. Currently, for income tax purposes, the depreciable real estate improvements are amortized over 39 years.

Is it appropriate to depreciate old, worn-out real estate improvements in economically depressed locations that may have a ten-year remaining economic life, but for income tax purposes, the investor is required to depreciate the improvements over the next 20 years remaining of the 39 years of depreciation? (If built after May 1993, or a 31.5-year period of depreciation is applicable if put in service after 1986 and before 1993.)

Today, many lenders are looking for the vacant-and-available value of property being mortgaged, as these institutions are basing loans on collateral value of the real property, whether an owner-occupied office building, industrial plant, commercial building, etc. What would mortgage loan terms be on commercial property without personal liability on the mortgage indebtedness? Could the difference be something other than real estate value, and/or could the difference be depreciated for IRS purposes as a business value? These interesting concepts are based on common logic and valuation procedures.

The assessor should be looking at the vacant-and-available status of all property for tax assessment purposes in states that assess on a fee simple, market value basis (as required, e.g., by the Michigan Constitution). Generally, value of recently leased commercial buildings could be greater than that of similar vacant buildings, which could take time to lease up and incur expenses during vacancy, including rent loss, leasing fees, management, insurance, debt service, property taxes, maintenance, security, utilities, etc. An assessor should not penalize a landlord of a vacant building by placing an assessed value equal to that of a similar occupied building; and the owner of leased property should not be required to pay taxes on property subject to existing occupancy (BEV). This analysis is applicable to the real estate investor's maximizing his/her after-tax cash flow position.

For some time, counselors and appraisers have used the DCF method to analyze and value property, including enterprises (BEV), that have not achieved market stabilization, as well as for properties that have contracted variable income streams. Investors/lenders often require various value estimates for a project, i.e., as is, as if complete and as if stabilized. These indicate a possible—

and very probable—BEV allocation. Assume there are two physically and functionally similar apartment buildings in similar economic locations. Assume one is vacant and one is in a stabilized operating condition. In good times it is easier and less time-consuming to fill up the vacant building, than in economic down times. This is indicative of a possible greater BEV in some properties that are in poor economic areas versus in good economic areas. The lease-up costs are generally not considered real estate and could reasonably be depreciable for income tax purposes.

These old residual techniques for land and buildings were developed in the mid- to late-1930s. Some articles analyze successful enterprises by applying residual techniques to the stabilized net income, and reasonably suggest that the difference between the net income necessary to justify the improvements and the projected pro-forma net income is the net income (value) that accrues to the non-realty components.

There are allocation methods based upon various formulas involving franchise value percentages and business portion allocations. An overall capitalization rate applicable to business-oriented real estate, such as a hotel, should be higher than a capitalization rate that is appropriate for a leased, high-profile fast food franchise.

In general, these approaches are reasonable. However, can these approaches be applicable to an economically marginal BEV property? A marginal BEV property could be any business-type of property located in an area where new competition or changing economics have limited the property's economic future. In a marginal operation, an interest rate on the land alone might require all of the net income from the enterprise to satisfy the demands of the land.

However, a marginal enterprise could have some BEV. The BEV could be the last component of value remaining, short of salvage value (furniture, carpeting, elevator cables, etc.). Not every BEV will represent enough net operating income to cover the depreciated value of all of the improvements, including land. This author's article, "Valuation of a Pari-Mutuel Race Track," *Appraisal Journal*, April 1989, states that in the valuation of a successful operation:

> "The depreciated value of the improvements (cost less physical, functional and economic obsolescence) plus land must be less than the capitalized value of the Enterprise because the difference has to be related to start-up and organizational costs, FF&E, the licenses and working capital, etc. These types of items, along with inventories, are always part of the operating enterprise.
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> If the capitalized value is less than the depreciated cost, the Practitioner must rethink the valuation. The value of the Real and Personal Property should be less than the value of the enterprise because the business components of value are generally always present in an operating business and exist to a point at which perhaps they are the only components of value. When this occurs, it is most likely that the appraiser has not calculated all of the functional obsolescence and physical deterioration and, most importantly, has not recognized all of the existent external obsolescence. If present, external obsolescence must be properly calculated and addressed. External obsolescence is basically the difference between the amount allocated to Real Property as obtained by use of the Income Capitalization Approach and the amount obtained by the Cost Approach based upon physical deterioration and functional obsolescence provided that both approaches have been properly executed."

The valuator should always go to the market when valuing the components of a BEV. If one can't find it in the market, one probably should not use it in an analysis. Find out how enterprises are put together, i.e., identify their components. The net operating income produced in an income approach must support all aspects within a going concern by providing a return on all components, such as land, building, licenses, inventories, start-up/organizational costs, etc.

A cost approach involves adding the land value and hard and soft building costs, including developer's profit, interest and taxes during construction, costs of licenses, fixtures, working capital, etc., including cost required to bring the going concern into a stabilized operating condition at the date of valuation.

This author is suggesting that in the allocation of improved real estate, one should look to the underlying land value. Vacant comparable land sales are appropriate for the valuation of a new property. When improvements are economically worn out, demolition costs would be deducted from the land value. There are generally no arm's-length vacant land sales in the marketplace to reflect the value of land as-if-vacant that is under normal operating improved properties. Hence, one could consider amortizing demolition costs to the as-if-vacant value over the remaining life expectancy of the improvements, which would allocate a higher appreciable valuation to the improvements for IRS after-tax cash flows.

At this point it is appropriate to address the subject of entrepreneurial profit. *The Dictionary of Real Estate Appraisal, Fourth Edition* defines entrepreneurial incentive as: "A market-derived figure that represents the amount an entrepreneur expects to receive for his or her contribution to a project and risk."

Reviewing a cost manual, or an architect's cost breakdown, indicates that there are many components of entrepreneurship that must be taken into account within the calculation described above. Consider the following: someone had to originate the idea. Idea people get paid for their good ideas; some even get paid for bad ideas. Regarding a hotel: someone created the idea; found an economically viable area for development; located a site and negotiated a sale for the site; selected a builder and architect; decided on elevations, floor plans, franchises; conducted investigations; and so on. Someone has to be paid, or an allowance made to compensate for these ideas, financial backing and courage. Normally, informed investors do not build something to have it worth, upon construction, only what it cost. There has to be a profit incentive (entrepreneurship) that is typically added to the improvement costs and reasonably allocated for income tax purposes.

It is not as simple as acquiring a McDonald's franchise and constructing a build-to-suit building. The more speculative and development-intensive, the greater the entrepreneurship needed to get the deal started. Entrepreneurship is not tangible real and/or personal property.

Shopping centers present their own unique challenge to determining BEV. Several articles written about potential BEV in shopping centers relate a BEV to percentage rent, and/or rent in excess of market rent. None of the articles seems to have developed the vacant and available approach to discovering the BEV. Placing a new shopping center on the open market and using a DCF analysis derives a value that could be based on market rent, or could be based on vacant-and-available subject to costs associated with obtaining occupancy. The costs required to bring a shopping center into stabilized operating condition (including entrepreneurship) can be subtracted from the DCF value to determine the value of the real property. The difference between this value and the value-in-operation is often attributable to the value of the intangible, non-realty components of the BEV.

Along with reference to percentage rents, numerous shopping center valuation articles cite management contracts in place, and various rental rates based on dollars per square foot of building area, depending on a unit's location, size and the center's tenant mix. This accounts for the fact that not every tenant in a major shopping center makes an equal financial contribution to the total income.

In any developed and reasonably well-managed shopping center, the calculation of a BEV using contract rent versus market rent and existing management contracts seems only to be a guessing game. A well-managed center does not necessarily mean a center that is financially successful, as it could also be past its prime or in financial difficulty. Good property managers attempt to maximize income over the remaining economic life of a property. Percentage rents, typically based on gross sales, are based on a tenant's business. Management fees are not the BEV of a property. After deducting a percentage of gross income for management fees, including any incentive fees, generally there still is BEV.

In most business-oriented operations, there are departments that are necessary for the total business to operate well, and these departments do not all contribute equally to the bottom line. In a typical full-service hotel, rooms generate the money and management hopes food and beverage components break even. Similarly, golf courses have pro shops and cart rentals; marinas have gas docks, boat repairs and/or boat sales.

Let's look at a typical enclosed shopping mall with a 2,000-square-foot store on each side of a corridor. One store is rented for $25 per square foot by a jeweler and the other rents to a coffee shop at $8 per square foot. What is the market rent for each store?

Appraisal literature reiterates that if market rent is more than contract rent, then a leasehold interest exists, and not a BEV. When contract rent is more than market rent, it is income to the going concern. Economics can and do change, sometimes overnight, and remember, excess profits often breed ruinous competition.

As appraisers press on with the challenge of analyzing going concerns and, within reason, calculating the BEV, we should continue trying various approaches for improvement. Often this is a matter of keeping in mind some of the basic principles and methodology discussed in this article. In good economic times and in good locations for a particular property, there is less risk achieving stabilized occupancy. In economic downturns, the property in good operating condition could have a greater BEV, as it is more difficult for a business-related property to reach stabilized operating condition. A DCF analysis allows changes to the allocation of non-realty items occasioned by economic times, conforming to the Uniform Standards of Professional Appraisal Practice, and further identifies non-realty items, which can be depreciated faster for after-tax cash flows.

And finally, start at the beginning! In a BEV property analysis, it is generally judged most wise and educational to consider starting from scratch, such as with a vacant-and-available allocation approach to value. How would a developer look at a property? What are the steps and costs needed to get the enterprise into its current condition as of a specific date? Get data and information from the market, if possible.

It is our responsibility as appraisers/counselors to advise clients of various possibilities for allocating non-realty items, which could dramatically affect after-tax cash flow that a property can offer. The real estate appraiser/counselor has the ability to be much more qualified than CPAs and others who often perform the required allocation of an enterprise transaction for the after-tax cash flow concerned investor. We appraisers are able to take a more in-depth look at the market and a wide variety factors—and thus offer a more creative and innovative approach. ■

Contributing to the ideas and editing of this article were Coleen Handlon-Shaull, general real estate appraiser, who has been associated with Integra Realty Resources in Detroit for more than 20 years, and Ken Blondell, MAI, president of Integra Realty Resources–Detroit, and Nelson's partner.