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SCCAI SUMMER CONFERENCE

INTANGIBLE ASSETS IN THE VALUATION OF GOING CONCERN REAL ESTATE

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Function and Specialization

- Real Property
- Transfer Pricing
- Litigation Support

Education, Licenses & Certifications

- Masters of Science in Real Estate, University of San Diego
- Alpha Sigma Gamma Award Recipient
- B.A. in Economics, University of California at San Diego
- Member, Appraisal Institute, MAI Designation #497209
- Member, American Society of Appraisers, ASA Designation # 106380
- Appraisal Institute Panel Member for Financial Reporting
- Contributing reviewer, The Appraisal of Real Estate, 14th Edition
- State of Arizona Real Estate Appraisers License # 31944
- State of California Real Estate Appraisers License # AG045014
- State of Colorado Real Estate Appraiser License #CG100042083
- State of Hawaii Real Estate Appraisers License # CGA1038
- State of Florida Real Estate Appraisers License # RZ3544
- State of Maine Real Estate Appraisers License # CG3337
- State of Michigan Real Estate Appraisers License # 31944
- State of Montana RE Appraisers License # REA-RAG-LIC-6037
- State of Oregon Real Estate Appraisers License # C001151
- State of Pennsylvania Real Estate Appraisers License # GA004001
- State of Texas Real Estate Appraisers License # 1380207
- State of Utah Real Estate Appraisers License # 8548636-CG00
- State of Virginia Real Estate Appraisers License # 4001017045
- State of Washington Real Estate Appraisers License # 1102240

Professional and Industry Experience

Justin is a Managing Director and West Region Leader of the Financial Reporting Practice within the Valuation & Advisory (V&A) Group at Cushman & Wakefield. The Financial Reporting Practice is a specialty practice within V&A focusing on engagements involving real estate related consulting services, with a primary focus on valuation for financial reporting (GAAP & IFRS), including fair value measurements (ASC Topic 820), purchase price allocations (ASC Topic 805), capital leases (ASC Topic 840), and reorganizations (ASC Topic 852).

Justin joined the San Diego office of Cushman & Wakefield in early 2015. Prior to joining Cushman & Wakefield, Mr. Glasser held a senior manager position in the real estate valuation practice of KPMG LLP, where he consulted with real estate clients in a variety of industries, including hospitality, healthcare, retail, residential development, manufacturing, and financial services. x

Representative Clients

- Ashford Hospitality Trust
- Auberge Resorts
- CBRE Global Investors
- Constellation Hotels
- DiamondRock Hospitality Co.
- Dubai World
- EPR Properties
- Excel Group
- GEM Realty Capital, Inc.
- Harrah's Entertainment Inc
- Hersha Hospitality Trust
- Hilton Hotels Corporation
- Hyatt Corporation
- Luxury Resorts & Hotels
- Marriott Vacation Worldwide Corp.
- MGM Mirage
- Pebblebrook Hotel Trust
- Rich Uncles
- SBE Hotel Group
- Skyline Hotels & Resorts
- Terreno Realty Corp.
- The Blackstone Group
- Tropicana Entertainment
- UBS Realty Investors, LLC
- Washington Holdings
- Westmont Hotels
- Westport Capital Partners LLC

BOB DIETRICH, *DIRECTOR*

Robert E. Dietrich, MAI, CRE, CCIM, MRICS
Director, National Specialty Practice

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Professional and Industry Experience

Robert E. Dietrich is the Director of the Specialty Valuation Practice of Colliers International Valuation & Advisory Services, and is located in the Newport Beach office.

Mr. Dietrich has performed valuations involving a wide variety of property types ranging from high rise offices to farms and ranches. He has appraised special purpose properties such as port facilities, ski resorts, and others. Areas of specialization include planned developments, subdivisions, leasehold/leased fee analyses, and project modeling. He has appraised all types of commercial, industrial, and multi-family properties in the Western United States for more than 30 years.

Mr. Dietrich has been designated as an expert in real estate valuation issues in courts and has testified on over 60 occasions in State Superior Court, Federal court, Bankruptcy Court, US Tax Court, JAMS, state and county assessment appeals boards, and others. He has been selected as an independent arbitrator for matters in Arizona and California.

Education, Licenses & Certifications

- B.S. University of Arizona
- Member, Board of Directors of the Appraisal Institute (2008 – 2012)
- President, Southern California Chapter of the Appraisal Institute (2014)
- President, Southern California CCIM Chapter (1997)
- Volunteer of Distinction Award, Appraisal Institute (July 2012)
- MAI designation - Appraisal Institute
- CRE designation – Counselors of Real Estate
- CCIM designation – CCIM Institute
- MRICS designation – Royal Institution of Chartered Surveyors
- Member – Lambda Alpha
- Licensed Appraiser (15 States including California, Arizona, and Nevada)

Representative Clients

- Latham & Watkins
- Department of Justice
- American Ag Credit
- Metropolitan Water District
- US General Services Administration
- AEGON USA Realty Advisors
- US Air Force
- Tribune Company

Representative Complex Assignments

- Compensation for inverse taking of water
- Rental value for a recreation lake in Southern California
- Valuation of largest development company in California
- Valuation of largest land holding and development in Bermuda
- Valuation of 2.2 million acre cattle ranch
- Valuation of Queen Mary Seaport development
- Valuation of highest grossing retail complex in US
- Valuation of 18,000 acres of almond orchards in Central Valley

Ice Breaker

ICE BREAKER

Is the dishwasher personal property or real property?

Evidence of Intangible Assets

EVIDENCE OF INTANGIBLE ASSETS

Real Property	FF&E (Personal Property)	Intangibles
Land	Furniture in rooms & public areas	Cash and equivalents (often partially excluded) AKA working capital
Building	Fixtures (Non- Realty)	Assembled workforce
Site Improvements	Equipment (kitchen, office, health care related, etc.)	Contracts with clients and vendors
Lease Interests	Plates, glasses, bedding, etc.	Franchise or flag
	Computer systems	Trademarks, copyrights and patents
	Inventory	Name and goodwill

All together are referred to as the Total Assets of the Business (TAB). However, one or more components is often excluded from the valuation.

EVIDENCE OF INTANGIBLE ASSETS

Uniform Standards of Professional Appraisal Practice (USPAP)

- Intangible Assets - Nonphysical assets, including but not limited to franchises, trademarks, patents, copyrights, goodwill, equities, securities, and contracts as distinguished from physical assets such as facilities and equipment.

- Standards Rule 1-4(g) - "When personal property, trade fixtures, or intangible items are included in the appraisal, the appraiser must analyze the effect on value of such non-real property items."

COMMUNICATING VALUE OPINIONS

Appraiser must communicate three things:

- The type of value being reported (market value, fair value, investment value, etc.)
- The assets or asset classes included in the value opinion
- The valuation premise
  - In Use (Going Concern)
  - In Exchange (Liquidation/Salvage Value)

VALUATION METHODS

Cost Approach:

Income Approach:

Direct Sales Comparison Approach:

VALUATION METHODS - COST APPROACH

	Real Property	Personal Property	Real & Pers. Property	Intangible Property	Total
Direct & Indirect Cost	$2,500,000	$210,000	$2,710,000	$150,000	$2,860,000
Entrepreneurial Incentive	$250,000	--	$250,000	$100,000	$350,000
Total Replacement Cost	$2,750,000	$210,000	$2,960,000	$250,000	$3,210,000
Depreciation:					
Physical Deterioration	($600,000)	($42,000)	($642,000)	$0	($642,000)
Functional Obsolescence	($200,000)	$0	($200,000)	$0	($200,000)
External Obsolescence	$0	$0	$0	$0	$0
Total Depreciation	($800,000)	($42,000)	($842,000)	$0	($842,000)
Depreciated Imps Value	$1,950,000	$168,000	$2,118,000	$250,000	$2,368,000
Land Value	$600,000	--	$600,000	--	$600,000
Value by the Cost Approach	$2,550,000	$168,000	$2,718,000	$250,000	$2,968,000

VALUATION METHODS - INCOME APPROACH

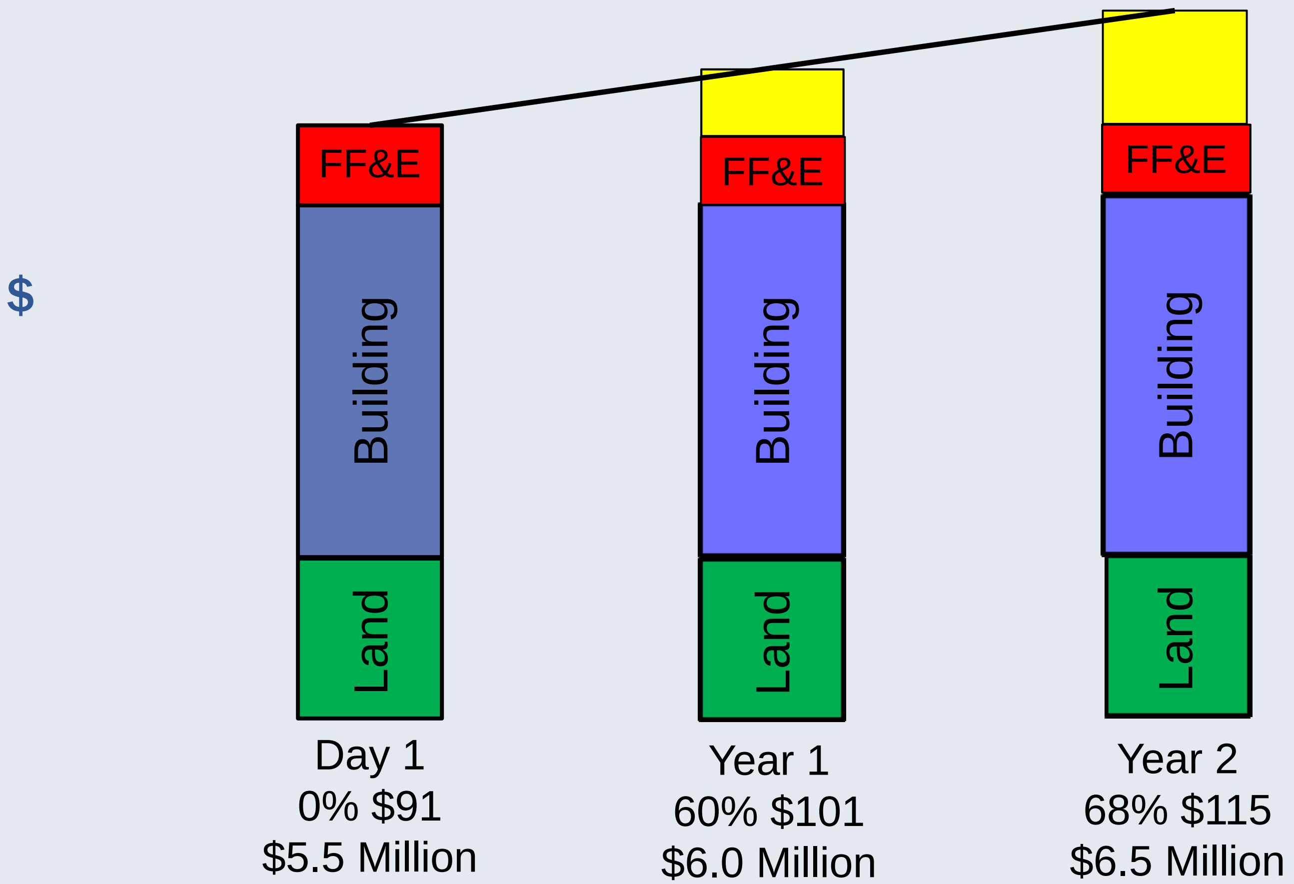
Sale Price (real property, personal property and intangible property): $2,900,000			
	Income	Rate/Factor	Type
Gross Revenue	$880,000	3.30	Revenue Multiplier
Cost of Goods Sold	-$130,000		
Gross Profit	$750,000	3.87	Gross Profit Multiplier
Payroll (excluding owner)	-$180,000		
Franchise Fees	-$35,000		
Other Operating Expenses	-$110,000		
Property Tax & Insurance	-$40,000		
SDE (seller's discretionary earnings)	$385,000	7.53	SDE Multiplier
Market Payroll for Seller's Labor	-$30,000		
EBITDA/EBITDARM	$355,000	8.17	EBITDA Multiplier
Management Fee	-$44,000		
Replacement Reserves (including F&E)	-$21,000		
Net Operating Income	$290,000	0.10	Overall Cap Rate

INTANGIBLE VALUE - GOING CONCERN

- Many properties are built for a specific use such as a hotel. The hotel business cannot operate without the real estate, and value of real estate can be impacted by going the concern.
- Are there intangible items included in the valuation of an operating hotel? If so, what are some of the intangible items?
  - Trained workforce
  - Brand
  - Contracts
  - Customer relationships
  - Advanced bookings
- How can the real estate value be separated from the going concern to avoid taxing or lending on value of intangible assets?

INTANGIBLE VALUE - GOING CONCERN

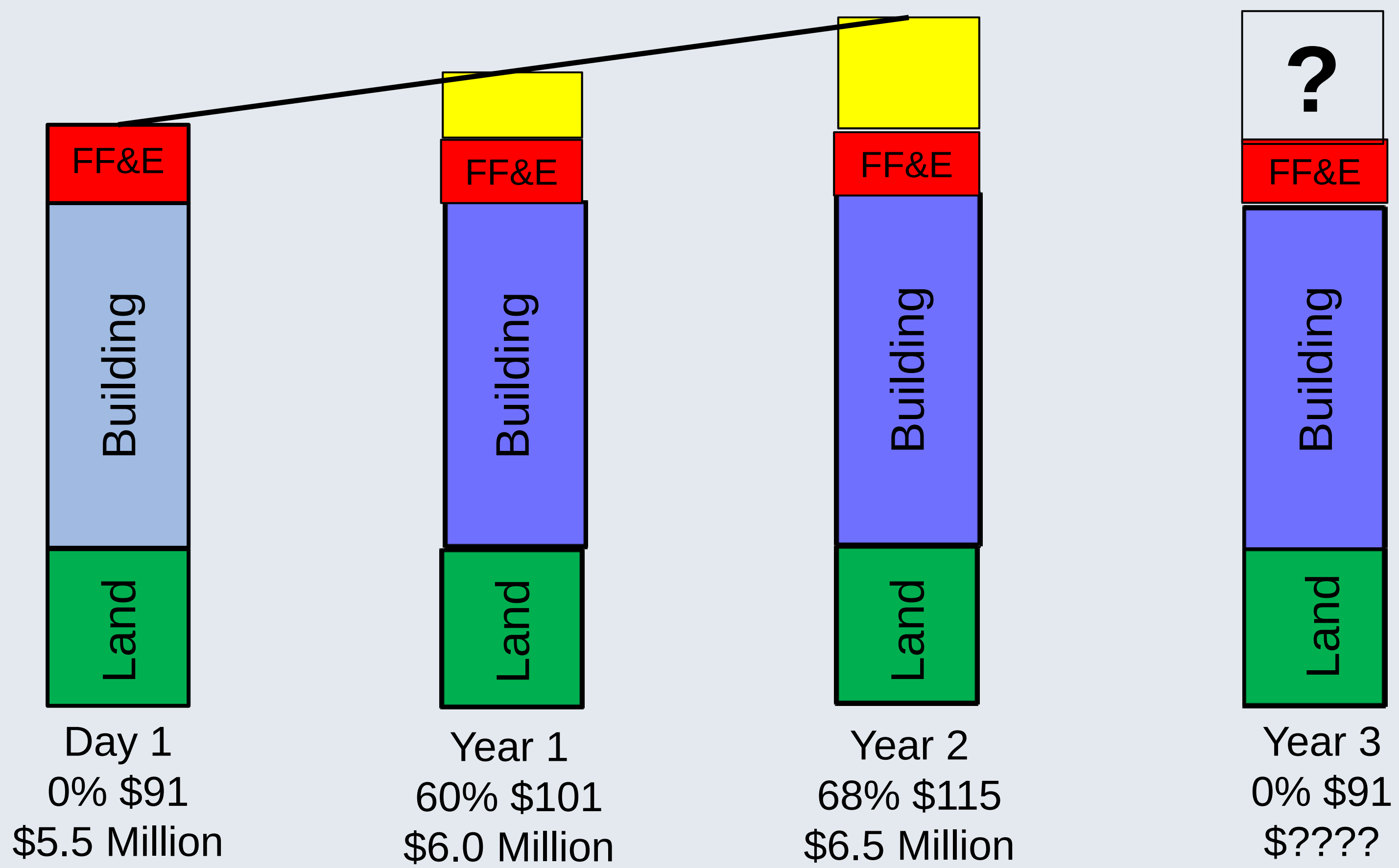
- Lets build a small hotel in Florida to see if we can identify intangible value.
- Assume Stabilized market 68% occupancy and $115 ADR, 2 years to stabilize.
- Land value $1 million, buildings $4 million, and FF&E $500,000.



INTANGIBLE VALUE - GOING CONCERN

INTANGIBLE VALUE - GOING CONCERN

- Without regard to inflation, where are we in year 3 after we shut the hotel down for 6 months?



Intangible Value Case Studies

INTANGIBLE VALUE - CASE STUDIES

- When dealing with properties built for a specific type of business, there may be an element of non-realty value in the going concern.

- If there is a non-realty element of intangible value, how do you identify and extract it?

INTANGIBLE VALUE - LEASES

Drug Store Example

- This type of leased property often creates a large intangible value component as well as real estate value.

Sale Price $4,000,000

Sale Price $3,000,000

INTANGIBLE VALUE - LEASES

Drug Store Example (continued)

Market Cost Approach:					Total	Per SF Bldg.
Land:						
$9	times	50,000	Sq. Ft.	=	$450,000	$30.00
Building:						
$150	times	15,000	Sq. Ft.	=	$2,250,000	$150.00
Subtotal:					$2,700,000	$180.00
Developer Profit:			7.0%		$189,000	$12.60
Development Costs:					$2,889,000	$192.60
Leaseup Adjustment:			4.0%		$115,560	$7.70
Value by Cost Approach:					$3,004,560	$200.30
Round to:					$3,000,000	$200.00

Income Approach (Local Market Rent and Tenant):		
Annual Market NNN Rent:	$240,000	$16.00
Cap at:	8.0%	
Property Value:	$3,000,000	$200.00

Income Approach Lease to Walgreens (National Credit):		
Annual Market NNN Rent:	$240,000	$16.00
Cap at:	6.0%	
Property Value:	$4,000,000	$266.67

INTANGIBLE VALUE - LEASES

Drug Store Example (continued)

On previous slide:

- Cost to develop and value based on capitalized market net income is \$3.0 million or \$200 per square foot. General retail stores in area sell for \$150 to \$225 per square foot.
- Leased to Walgreens, the value is \$4.0 million or \$267 per square foot. Walgreens-leased drug stores sell for \$250 to \$350 per square foot in region.
- What is the \$1.0 million difference in value attributed to?
- Tangible real estate, tangible personal property, or intangible value?

INTANGIBLE VALUE - LEASES

Drug Store Example (continued)

Legal Basis for Extracting Intangible Value:

- Walgreens believed a property in Madison, Wisconsin was over-assessed due to taxation of intangible value.
- Walgreens appealed to Assessor and lost and then sued the City (*Walgreen Co. v. City of Madison*).
- Walgreens lost at the trial, but appealed and the Wisconsin Supreme Court overturned the verdict.
- The supreme court directed that the assessment would be based on market rental rates in conformance with recognized appraisal authorities, such as the *Appraisal of Real Estate*.
- Going forward in Wisconsin, contract rents will not be considered for assessment purposes due to inclusion of non-taxable intangible assets.

Financial Reporting

FINANCIAL REPORTING

- Purchase Price Allocations
  - User Profile
  - ASC 805, *Business Combinations*
  - Standard (Fair Value) & Premise of Value (In Exchange)
  - Allocation Process
  - Case Study (Office)

USER PROFILE

- Public Companies
  - REITs
    - Industrial
    - Office
    - Retail
    - Apartment
    - Self-Storage
    - Lodging
    - Healthcare (e.g., assisted living)
    - Manufactured Home Communities
    - Single Family REITs
  - Others
    - Joint Ventures w/ Public Companies
- Private Companies
  - Looking to go public
    - Requires four years audited financials

ASC 805, BUSINESS COMBINATIONS

"An acquiring entity shall <u>allocate the cost of an acquired entity to the assets acquired and liabilities assumed</u> based on their estimated fair values at date of acquisition."

- Assets <u>include intangible assets</u> that meet [either of] the recognition criteria, regardless of whether they had been recorded in the financial statements of the acquired entity."
  - <u>Contractual-Legal Criterion</u> – Asset(Liability) arises from contractual or other legal rights (regardless of whether they can be transferred or separated)
  - <u>Separability Criterion</u> – Asset(Liability) capable of being separated from acquired entity(property), or can be sold in combination with a related contract, asset or liability

STANDARD & PREMISE OF VALUE

- The standard of value for purchase price allocation in accordance with ASC 805 is Fair Value (as defined by ASC 820, Fair Value Measurements).

- The fair value of a stand-alone asset (i.e., investment property) is based on an “In-Exchange” Premise.

- Under the “In-Exchange” Premise fair value, as defined by ASC 820, *Fair Value Measurements*, is generally consistent with market value.

IDENTIFICATION OF LEASE INTANGIBLES

Purchase Accounting and Acquisition of Real Estate

- *Our methodology of allocating the cost of acquisitions to assets acquired and liabilities assumed is based on estimated fair values, replacement cost and appraised values. When we acquire operating real estate properties, the purchase price is allocated to land and buildings, intangibles such as in-place leases, and to current assets and liabilities acquired, if any. Such valuations include a consideration of the non-cancelable terms of the respective leases as well as any applicable renewal period(s). The fair values associated with below market renewal options are determined based on a review of several qualitative and quantitative factors on a lease-by-lease basis at acquisition to determine whether it is probable that the tenant would exercise its option to renew the lease agreement. These factors include: (1) the type of tenant in relation to the property it occupies, (2) the quality of the tenant, including the tenant's long term business prospects, and (3) whether the fixed rate renewal option was sufficiently lower than the fair rental of the property at the date the option becomes exercisable such that it would appear to be reasonably assured that the tenant would exercise the option to renew. Each of these estimates requires a great deal of judgment, and some of the estimates involve complex calculations.*

Financial Impact

- *These allocation assessments have a direct impact on our results of operations because if we were to allocate more value to land, there would be no depreciation with respect to such amount. If we were to allocate more value to the buildings, as opposed to allocating to the value of tenant leases, this amount would be recognized as an expense over a much longer period of time, since the amounts allocated to buildings are depreciated over the estimated lives of the buildings whereas amounts allocated to tenant leases are amortized over the remaining terms of the leases.*

IDENTIFICATION OF LEASE INTANGIBLES

REALTY INCOME
The Monthly Dividend Company®

Purchase Accounting and Acquisition of Real Estate

- When acquiring a property for investment purposes, we typically allocate the fair value of real estate acquired to: (1) land, (2) building and improvements, and (3) identified intangible assets and liabilities, based in each case on their estimated fair values.
- Our fair value determinations are based on a real estate valuation for each property, prepared either internally or by an independent valuation firm.

Lease Intangibles

- Intangible assets and liabilities consist of above-market or below-market lease value of in-place leases, the value of in-place leases, and tenant relationships, as applicable.
- In allocating the fair value to identified intangibles for above-market or below-market leases, an amount is recorded based on the present value of the difference between (i) the contractual amount to be paid pursuant to the in-place lease and (ii) our estimate of fair market lease rate for the corresponding in-place lease, measured over the remaining term of the lease.

IDENTIFICATION OF LEASE INTANGIBLES

Purchase Accounting and Acquisition of Real Estate

- When acquiring a property for investment purposes, we allocate the purchase price to *land, building, improvements* and equipment based on their relative fair values. For properties acquired with in-place leases, *we allocate the purchase price of real estate to the tangible and intangible assets and liabilities acquired based on their estimated fair values.* In making estimates of fair values for this purpose, we use a number of sources, including *independent appraisals* and information obtained about each property *as a result our pre-acquisition due diligence* and its marketing and leasing activities.

Lease Intangibles

- *Lease intangibles represent the value of in-place leases and above- or below-market leases*. In-place lease intangibles are valued based on an estimates of costs related to tenant acquisition and the carrying costs that would be incurred during the time it would take to locate a tenant if the property were vacant, considering current market conditions and costs to execute similar leases at the time of the acquisition.

IDENTIFICATION OF LEASE INTANGIBLES

TERRENO

Purchase Accounting and Acquisition of Real Estate

- Upon acquisition of a property, which are accounted for as business combinations, we estimate the fair value of acquired tangible assets (consisting generally of land, buildings and improvements) and intangible assets and liabilities (consisting generally of the above and below-market leases and the origination value of all in-place leases).

Lease Intangibles

- The fair value of the above and below-market leases is based on the present value of the difference between the contractual amounts to be received pursuant to the acquired leases (using a discount rate that reflects the risks associated with the acquired leases) and our estimate of the market lease rates measured over a period equal to the remaining term of the leases plus the term of any below-market fixed rate renewal options.
- The origination value of in-place leases is based on costs to execute similar leases including commissions and other related costs. The origination value of in-place leases also includes real estate taxes, insurance and an estimate of lost rent revenue at market rates during the estimated time required to lease up the property from vacant to the occupancy level at the date of acquisition

IDENTIFICATION OF LEASE INTANGIBLES

CubeSmart storage + logistics

Purchase Accounting and Acquisition of Real Estate

- When facilities are acquired, the purchase price is allocated to the tangible and intangible assets acquired and liabilities assumed based on estimated fair values.

Lease Intangibles

- In allocating the purchase price for an acquisition, the Company determines whether the acquisition includes intangible assets or liabilities. <u>The Company allocates a portion of the purchase price to an intangible asset attributed to the value of in-place leases</u>.

- Substantially all of the leases in place at acquired facilities are at market rates, as the majority of the leases are month-to-month contracts. Accordingly, to date, no portion of the purchase price has been allocated to above- or below-market lease intangibles. <u>To date, no intangible asset has been recorded for the value of customer relationships, because the Company does not have any concentrations of significant customers and the average customer turnover is fairly frequent</u>.

PROCESS (STEP-BY-STEP)

- Step 1: Validate Purchase Price ('As Is' fair value).
- Step 2: Determine "As-If-Vacant" fair value of property.
- Step 3: Allocate the "As-If-Vacant" fair value to land, building, site improvements, and FF&E.
- Step 4: Calculate remaining purchase price to allocate.
- Step 5: Allocate a portion of remainder (calculated in Step 4) to above- and below- market leases (leasehold assets and liabilities).
- Step 6: Allocate a portion of remainder (calculated in Step 4) to 'Lease-In-Place'.
- Step 7: Allocate a portion of remainder (calculated in Step 4) to tenant (customer) relationships, if applicable.
- Step 8: Calculate cash equivalency of assumed debt, if applicable, and allocate a portion of remainder (calculated in Step 4) to debt asset/liability.
- Step 9: Reconcile fair value estimates and allocate remaining (intangible) value, if any, to goodwill.

PROCESS (STEP 1)

Step 1: Validate Purchase Price ('As Is')

- Standalone Transactions
  - Arm's Length
  - Adequate Exposure
  - All Cash (or Equivalent)
  - Orderly Transaction

Note: Typically some sort of benchmarking is requisite.

PROCESS (STEP 2)

Step 2: Determine "As-If-Vacant" fair value

- Income Approach
  - Discounted Cash Flow Method
  - Direct Capitalization w/ Lease Up Deductions

- Considerations
  - Consistency with 'As Is' assumptions in evaluating intangible assets
    - Hold period
    - TI Allowance
    - Leasing Commissions
    - Absorption/Downtime
  - Excess land valued separately (via Market Approach)

PROCESS (STEP 3)

Step 3: Allocate the "As-If-Vacant" fair value to land, building, site improvements, and FF&E.

- Cost Approach
  - *Land (Market Approach)*
    - Can be a significant challenge, especially for large assets in dense, urban environments.
    - Goodwill residual v. Land Residual proponents
  - *Building & Site Improvements (RCNLD)*
    - Replacement Cost New Less Depreciation (RCNLD)
    - Calculating the building fair value as a residual (i.e., As If Vacant Value less Land Value) is prohibited
    - The 'As-If-Vacant' value (from income approach) is used to benchmark the RCNLD (rule of thumb ± X percent)
    - Indirect Costs and Profit Margin assume vacant building (i.e., no lease up adjustment)
  - FF&E (Market Approach or RCNLD)
    - Many transactions may not include FF&E, or entity may account for it separately.
- Reconciliation
  - Cost Approach & Income Approach (As-If-Vacant)
    - Variance ± X percent (rule of thumb)
    - Results from Cost Approach utilized for allocation

PROCESS (STEP 4)

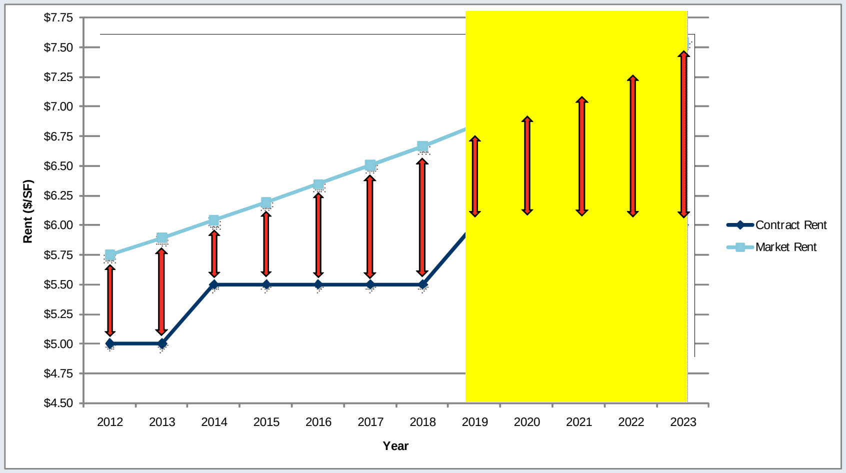
- Step 4: Calculate remaining purchase price to allocate.
  - Subtract 'As-if-Vacant' fair value from purchase price
    - Remainder reflects fair value of intangibles
      - Above / (below) market leases
      - Lease-In-Place (cost avoidance)
        - Lost income during lease up
          - Rent + Reimbursements
        - Tenant Improvement Allowances
        - Commissions
        - Legal & Marketing expense

        i.e., Lease origination costs
      - Tenant (Customer) Relationships (if applicable)
      - Debt Asset/Liability (if applicable)
      - Goodwill (if applicable)
        - Goodwill v. Land Residual debate

PROCESS (STEP 5)

Step 5: Allocate a portion of remainder (calculated in Step 4) to above- and below- market leases.

- Income Approach
  - Estimate market rent
  - Forecast contract rent
  - Forecast market rent
  - Subtract forecast market rent from contract rent
  - Present value cash flow variance
  - Considerations
    - Options (assume exercised if below market)
      - "significant economic compulsion" = 10%?, 5%?, ???
      - Case Study: Cedar Realty Trust
    - Expense reimbursements
    - Materiality Thresholds (start/end dates, percent variance)



Period	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
Contract Rent	5.00	5.00	5.50	5.50	5.50	5.50	5.50	6.00	6.00	6.00	6.00	6.00
Market Rent	5.75	5.89	6.04	6.19	6.35	6.51	6.67	6.83	7.01	7.18	7.36	7.54
Difference	-0.75	-0.89	-0.54	-0.69	-0.85	-1.01	-1.17	-0.83	-1.01	-1.18	-1.36	-1.54

PROCESS (STEP 5)

Step 5: Allocate a portion of remainder (calculated in Step 4) to above- and below- market leases.

- Discussion Topic
  - Contract Escalations vs. Market Inflation
  - Example:
    - Grocery anchor signed today for 20 year term, $10/SF with no escalations
    - Market standard is that similar leases would be signed without any escalations
    - Assume annual market inflation is 3% per year (over the long-run projection)
    - Is the flat lease a favorable lease to the tenant?
    - Is the flat lease representative of market terms?

PROCESS (STEP 6)

- Step 6: Allocate a portion of remainder (calculated in Step 4) to 'Lease-In-Place'.
  - Think of it as "cost avoidance"
  - Lease-In-Place includes (for example)
    - Leasing Commissions
    - Legal & Marketing Costs
    - Downtime
    - Rent Abatements
    - Expense Reimbursement
    - Lost Rent
    - Tenant Improvement Allowance
  - Pro Rata Remaining Lease Term

PROCESS (STEP 6)

Step 6: Allocate a portion of remainder (calculated in Step 4) to 'Lease-In-Place'.

- Discussion Topic
  - Sale-Leaseback Transaction
  - For a sale-leaseback, is there a LIP intangible?
  - Technically, the lease is signed after the asset is purchased (not "in-place" at the time of purchase)
  - The economics of the transaction are impacted by the leaseback agreement (most likely the purchase does not occur without the leaseback arrangement)
  - Does this meet one of the two intangible asset requirements?
    - Contractual-Legal Criterion – Asset(Liability) arises from contractual or other legal rights (regardless of whether they can be transferred or separated)
    - Separability Criterion – Asset(Liability) capable of being separated from acquired entity(property), or can be sold in combination with a related contract, asset or liability

PROCESS (STEP 7)

- Step 7: Allocate a portion of remainder (calculated in Step 4) to tenant (customer) relationships, if applicable.
  - An existing relationship with a customer/tenant may give rise to intangible value to the acquirer in that there may be cost savings associated with the relationship (e.g., the potential reduced expenditure arising from the renewal of an in-place tenant).
    - Probability-weighted present value of future expected cost savings driven by the relationship (avoided downtime between leases, avoided TI allowance, etc.)
  - In practice, we do not typically see a value assigned to tenant relationships. This is an advanced concept which falls outside the scope of our discussion today.

PROCESS (STEP 8)

- Step 8: Calculate cash equivalency of assumed debt, if applicable.
  - Accounts and notes payable, long-term debt, and other claims payable must be assigned amounts “at present values of amounts to be paid determined at appropriate current interest rates.”
  - If a mortgage is assumed in the acquisition of a property, there may be an intangible asset to the extent that the assumed mortgage features a below market coupon.
  - Likewise, assumed mortgages which feature above market coupons represent an assumed liability to the buyer.
  - This is an advanced concept which falls outside the scope of our discussion today.

PROCESS (STEP 9)

Step 9: Reconcile fair value estimates and allocate remaining (intangible) value, if any, to goodwill.

- Variance Greater Than 5 percent? (Or should it be 3 percent?)
  - In the event the sum of the allocated fair value estimates for land, building & site improvements, and intangibles exceeds or falls short of the purchase price by more than X percent, this may be indication of goodwill or a bargain purchase; however, one should revisit assumptions before making this conclusion.

- Variance Less Than or Equal to 5 (or 3?) percent?
  - In the event the sum of the allocated fair value estimates for land, building & site improvements, and intangibles or falls at or within X percent of the purchase price, a pro rata adjustment (push factor) is made to the fair value estimates (with the exception of debt/financial instruments) to reconcile to the purchase price.

CASE STUDY (OFFICE)

Transaction Overview	
Sale Price	$36,150,000
Sale Date	8/7/2013

Property Characteristics	
Type	Office
Class	C
Year Built	1997
Gross Building Area (SF)	215,688
Parking Structure (SF)	297,000
Site Area	62,006
Rentable Area (SF)	147,447
Construction Type	Concrete/Steel Frame
Number of Stories	9
Land Size (Acres)	3.11
Land Size (SF)	135,472

CASE STUDY (OFFICE)

	Fair Value
Net Purchase Consideration to be Allocated:	$ 36,150,000
As-Is	36,150,000
Variance	0.00%
Tangible Assets	
As-Vacant	-
Land	-
Building Improvements	-
Site Improvements	-
Total Tangible Assets	**-**
Intangible Assets	
Leasehold (Building)	
Total Advantage	-
Total Disadvantage	-
Total	-
In Place Lease	-
Total Intangible Assets	**-**
Total Assets Allocated	**$ -**

- Step 1: Validate Purchase Price ('As Is').
  - Standalone Transaction
    - Arm's Length
    - Adequate Exposure
    - All Cash (or Equivalent)
    - Orderly Transaction
      - No. Typically some sort of benchmarking is requisite

CASE STUDY (OFFICE)

		Fair Value
Net Purchase Consideration to be Allocated:	$	36,150,000
As-Is		36,150,000
Variance		0.00%
Tangible Assets		
As-Vacant		30,890,000
Land		-
Building Improvements		-
Site Improvements		-
Total Tangible Assets		**-**
Intangible Assets		
Leasehold (Building)		
Total Advantage		-
Total Disadvantage		-
Total		-
In Place Lease		-
Total Intangible Assets		**-**
Total Assets Allocated	**$**	**-**

Step 2: Determine "As-If-Vacant" fair value.

CASE STUDY (OFFICE)

	Fair Value
Net Purchase Consideration to be Allocated:	$ 36,150,000
As-Is	36,150,000
Variance	0.00%
Tangible Assets	
As-Vacant	30,890,000
Land	2,992,263
Building Improvements	-
Site Improvements	-
Total Tangible Assets	-
Intangible Assets	
Leasehold (Building)	
Total Advantage	-
Total Disadvantage	-
Total	-
In Place Lease	-
Total Intangible Assets	**-**
Total Assets Allocated	**$ -**

Step 3: Allocate the "As-If-Vacant" fair value to land…

CASE STUDY (OFFICE)

	Fair Value
Net Purchase Consideration to be Allocated:	$ 36,150,000
As-Is	36,150,000
Variance	0.00%
Tangible Assets	
As-Vacant	30,890,000
Land	2,992,263
Building Improvements	26,418,467
Site Improvements	227,668
Total Tangible Assets	**29,638,398**
Intangible Assets	
Leasehold (Building)	
Total Advantage	-
Total Disadvantage	-
Total	-
In Place Lease	-
Total Intangible Assets	**-**
Total Assets Allocated	**$ -**

Step 3: ...and to building and site improvements.

CASE STUDY (OFFICE)

	Fair Value
Net Purchase Consideration to be Allocated:	$ 36,150,000
As-Is	36,150,000
Variance	0.00%
Tangible Assets	
As-Vacant	30,890,000
Land	2,992,263
Building Improvements	26,418,467
Site Improvements	227,668
Total Tangible Assets	**29,638,398**
Intangible Assets	
Leasehold (Building)	
Total Advantage	-
Total Disadvantage	-
Total	-
In Place Lease	-
Total Intangible Assets	**-**
Total Assets Allocated	**$ -**

Step 4: Calculate remaining purchase price to allocate.

$36,150,000
-$29,638,398
$6,511,602

CASE STUDY (OFFICE)

	Fair Value
Net Purchase Consideration to be Allocated:	$ 36,150,000
As-Is	36,150,000
Variance	0.00%
Tangible Assets	
As-Vacant	30,890,000
Land	2,992,263
Building Improvements	26,418,467
Site Improvements	227,668
Total Tangible Assets	**29,638,398**
Intangible Assets	
Leasehold (Building)	
Total Advantage	810,354
Total Disadvantage	(248,265)
Total	562,089
In Place Lease	-
Total Intangible Assets	**562,089**
Total Assets Allocated	**$ -**

Step 5: Allocate a portion of remainder (calculated in Step 4) to above- and below- market leases.

CASE STUDY (OFFICE)

Step 5 (Detailed Look)

Tenant Name:	Appraisal Institute
Square Feet	4,547
End Date	4/18
Remaining Months	57

	Year 1	Year 2	Year 3	Year 4	Year 5 (Partial Year)	Year 6	Year 7	Year 8	Year 9	Year 10
Contract Base Rent ($/SF)	20.91	21.33	21.76	22.19	16.89	-	-	-	-	-
Contract Reimbursement ($/SF)	8.45	8.57	8.88	9.15	6.91					
	29.36	29.90	30.64	31.34	23.80	-	-	-	-	-
Market Rent	22.50	23.18	24.33	25.55	19.74	-	-	-	-	-
Market Reimbursement ($/SF)	8.57	8.69	8.94	9.22	6.97					
	31.07	31.87	33.27	34.77	26.71	-	-	-	-	-
Variance ($/SF)	(1.71)	(1.97)	(2.63)	(3.43)	(2.91)	-	-	-	-	-
%	-5.50%	-6.18%	-7.91%	-9.86%	-10.89%	-	-	-	-	-
Refined Variance ($)	-7,775	-8,958	-11,959	-15,596	-13,232	-	-	-	-	-

Discount rate	8.25%
PV Variance	($44,515)
PV Contract Rent	$525,765
% Contract Rent	-8%

Don't forget generally accepted materiality thresholds....

- *Exclude leases with start/end dates within (x) months of Acquisition Date*
- *Exclude leases with variance within (x) percent of (contract or market) rent*

CASE STUDY (OFFICE)

	Fair Value
Net Purchase Consideration to be Allocated:	$ 36,150,000
As-Is	36,150,000
Variance	0.00%
Tangible Assets	
As-Vacant	30,890,000
Land	2,992,263
Building Improvements	26,418,467
Site Improvements	227,668
Total Tangible Assets	**29,638,398**
Intangible Assets	
Leasehold (Building)	
Total Advantage	810,354
Total Disadvantage	(248,265)
Total	562,089
In Place Lease	5,549,514
Total Intangible Assets	**6,111,603**
Total Assets Allocated	**$ 35,750,001**

Step 6: Allocate a portion of remainder (calculated in Step 4) to 'Lease-In-Place'.

CASE STUDY (OFFICE)

Step 6 (Detailed Look)

- Lease-In-Place includes (for example)
    - Leasing Commissions
    - Legal & Marketing Costs
    - Downtime
    - Rent Abatements
    - Expense Reimbursement
    - Lost Rent
    - Tenant Improvement Allowance

CASE STUDY (OFFICE)

Step 6 (Detailed Look)

- Leasing Commissions
- Legal & Marketing Costs

(i)						
SF	Leasing Commission	Legal & Marketing	RUL (Months)	Market Terms (Months)	Remaining % Market Term	Total Leasing Cost
(a)	(b)	(c)	(d)	(e)	(f) = (d) / (e)	(g) = (c) * (f) * Rent + (a) * (b) * (f)
4,547	$5.00	3.0%	57	60	95.0%	$ 36,583

CASE STUDY (OFFICE)

Step 6 (Detailed Look)

- Downtime
- Rent Abatements
- Expense Reimbursement

(ii)						
SF	Downtime (Months)	Rent Abatement (Months)	Downtime + Abatement	RUL (Months)	Monthly Expenses	Total Reimbursement Revenue
(a)	(b)	(c)	(d) = (b) + (c)	(e)	(f)	(g) = (d) * (f)
4,547	6.0	4.0	10.0	57	$ 8.45	$ 84.50

CASE STUDY (OFFICE)

Step 6 (Detailed Look)

- Lost Rent
  - Discussion Point - Present Value

(iii)							
SF	Downtime (Months)	Rent Abatement (Months)	Downtime + Abatement	RUL (Months)	Market Base Rent Per SF (Monthly)	Total Rent (Monthly)	Lost Rent
(a)	(b)	(c)	(d) = (b) + (c)	(e)	(f)	(g) = (a) * (f)	(h) = (d) * (g)
4,547	6.0	4.0	10.0	57	$ 1.88	$ 8,526	$ 85,256

CASE STUDY (OFFICE)

Step 6 (Detailed Look)

- Tenant Improvement Allowance
  - Discussion Point – Tangible or Intangible Asset?

(iv)					
SF	TI Allowance (PSF)	RUL (Months)	Market Terms (Months)	Remaining % Market Term	Total TI's
(a)	(b)	(c)	(d)	(e) = (c) / (d)	(f) = (a) * (b) * (e)
4,547	$ 2.00	57	60	95.0%	$ 8,639

CASE STUDY (OFFICE)

Step 6 (Detailed Look)

- Lease-In-Place Value (Total)

(i)	(ii)	(iii)	(iv)	
Total Leasing Cost	Total Reimbursement Revenue	Lost Rent	Total TI's	LIP Value
(a)	(b)	(c)	(d)	(e) = (a) + (b) + (c) + (D)
$ 36,583	$ 84.50	$ 85,256	$ 8,639	$ 130,563

CASE STUDY (OFFICE)

Step 9: Reconcile fair value estimates and allocate remaining (intangible) value, if any, to goodwill.

	Fair Value	Adjustment Factor	Fair Value Allocated
Net Purchase Consideration to be Allocated:	**$ 36,150,000**		**$ 36,150,000**
As-Is	36,150,000		36,150,000
Variance	0.00%		
Tangible Assets			
As-Vacant	30,890,000	1.0112	31,240,000
Land	2,992,263	1.0112	3,030,000
Building Improvements	26,418,467	1.0112	26,710,000
Site Improvements	227,668	1.0112	230,000
Total Tangible Assets	**29,638,398**		**29,970,000**
Intangible Assets			
Leasehold (Building)			
Total Advantage	810,354	1.0112	820,000
Total Disadvantage	(248,265)	1.0112	(250,000)
Total	562,089		570,000
In Place Lease	5,549,514	1.0112	5,610,000
Total Intangible Assets	**6,111,603**		**6,180,000**
Total Assets Allocated	**$ 35,750,001**		**$ 36,150,000**

COMMON PITFALLS AND MISTAKES

- Replacement Cost New Less Depreciation (RCNLD)
  - Utilize the cost approach (RCNLD) to support the allocated building value; do not base allocation on a building residual.
  - Include (don't exclude) soft costs (those excluded from MVS base costs) and developers profit in the RCNLD calculation. But how much?
  - Do not reconcile RCNLD (inclusive of land) to purchase price.
  - Include support for effective age and depreciation; older age may reflect deferred maintenance and younger age reflects renovations and capital improvements.

IRC § 1060 (TAX ALLOCATION)

- Under Internal Revenue Code (IRC) § 1060, an applicable asset acquisition is any transfer, whether direct or indirect, of a group of assets if the assets transferred constitute a trade or business in the hands of either the seller or the purchaser and the purchaser's basis in the transferred assets is determined wholly by reference to the purchaser's consideration.
- For purposes of determining the seller's amount realized for each of the assets sold in an applicable asset acquisition, the seller allocates consideration to all the assets sold by using the residual method under §§ 1.338–6 and 1.338–7.
- Under the residual method the market value is allocated to land and building (i.e., Class V assets) and the intangible value attributed to the in-place-leases is allocated to building improvements.

TAKE AWAY…

- When performing a purchase price allocation for tax reporting purposes (IRC 106), the lease intangibles are classified as Class V assets (real property interests) and allocated to building.

- Using the same as example as before, the allocation for tax reporting purpose would be as follows:

Purchase Price Allocation					
		ASC 805			**IRC § 1060**
Purchase Price	**$**	**36,150,000**		**$**	**36,150,000**
Land		3,030,000	Land		3,030,000
Building & Site Improvements		26,940,000	Building & Site Improvements		33,120,000
Building Advantage/Disadvantage		570,000			
In Place Lease		5,610,000			

SBA Issues With Intangible Asset Valuation

SBA ISSUES

SOP 50 10 5(H) MAY 2015

SUBPART B

When valuing the collateral, the lender must not include the contributory value of any rental income or the value of any intangible assets contained in the appraisal.

SBA ISSUES

SOP 50 10 5(H) MAY 2015 (MUSTS)

Small Business Administration
50-10(5)C-ch.3:2. APPRAISAL REQUIREMENTS(7) If the appraisal engagement letter asks the appraiser for a business enterprise or going concern value, the appraiser must allocate separate values to the individual components of the transaction including land, building, equipment and business. When the collateral is a special purpose property, the appraiser must be experienced in the particular industry.

SBA ISSUES

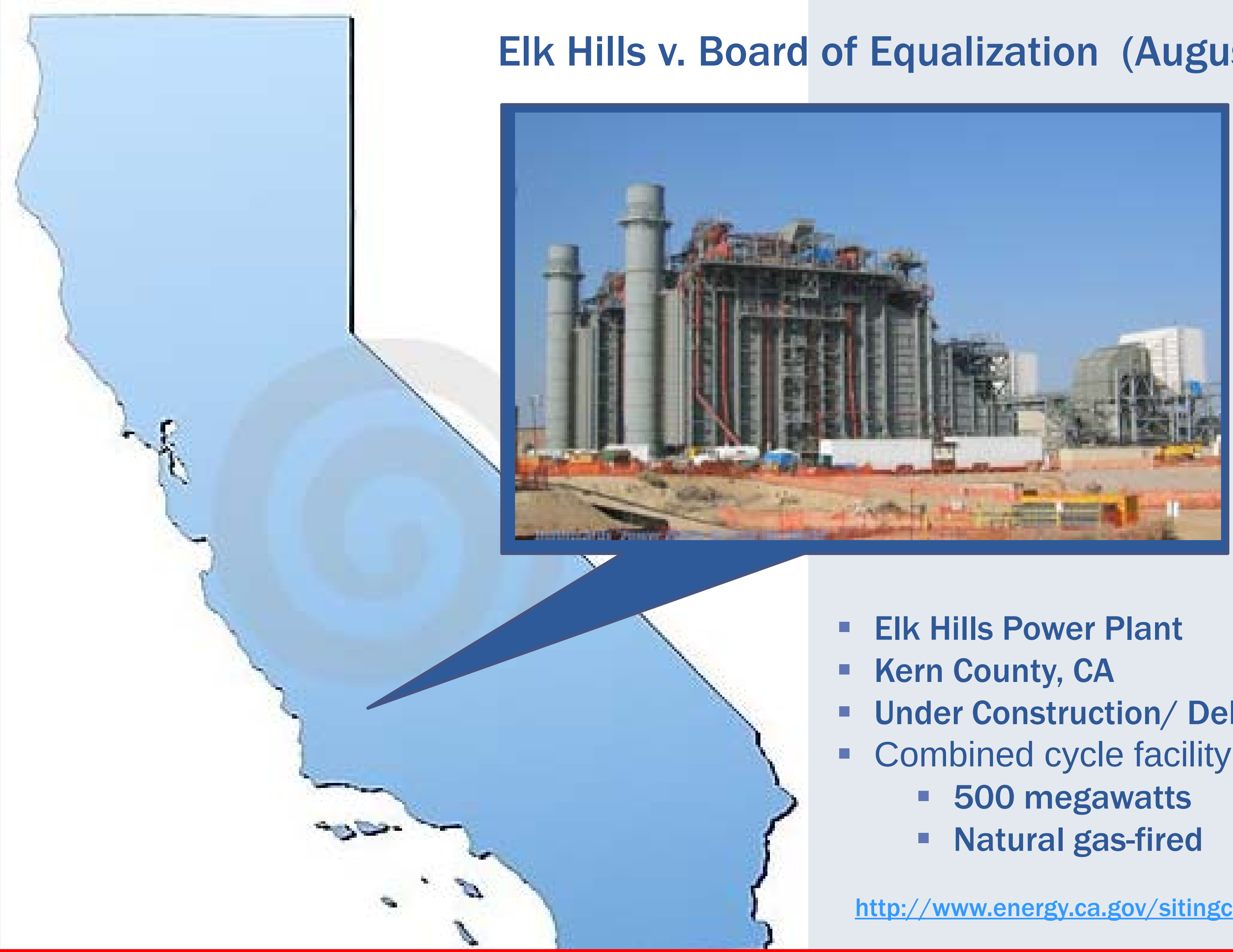
SOP 50 10 5(H) REAL ESTATE AND BUSINESS APPRAISALS

- Appraisals must be in compliance with the Uniform Standards of Professional Appraisal Practice (USPAP).
- Real Estate Appraiser must be state-certified and have no conflicts.
- Business appraisals requires ASA, CBA or other BV credential.
- Special Purpose Property is a limited-market property with a unique physical design, special construction materials, or a layout that restricts its utility to the specific use for which it was built.
  - The appraisal must allocate separate values to the individual components of the transaction including land, building, equipment and intangible assets.
  - The Certified General Real Property Appraiser must have completed no less than four going concern appraisals of equivalent special use property as the property being appraised, within the last 36 months, as identified in the qualifications portion of the Appraisal Report.

Court Cases

ELK HILLS CASE

Elk Hills v. Board of Equalization (August 2013)



- Elk Hills Power Plant
- Kern County, CA
- Under Construction/ Delivery in 2020
- Combined cycle facility
  - 500 megawatts
  - Natural gas-fired

http://www.energy.ca.gov/sitingcases/elkhills/

ELK HILLS CASE - CONTINUED

- Tax Payer - Elk Hills Power, LLC
- In 1999, Elk Hills applied for a permit to construct and operate a power plant
- Required to purchase Emission Reduction Credits (ERCs) to offset emissions
- Cost of ERCs was $11M
- The Board of Equalization (BOE) used the cost approach and the income approach to calculate the unitary value of the plant.
- In applying the cost approach, the BOE added the estimated cost of replacing the ERCs.
- In applying the income approach, the BOE chose not to deduct the value of the ERCs from the overall value of the plant.

ELK HILLS CASE - CONTINUED

The Supreme Court citations (August 2013):

- Section 212 (c) and Section 110 (d) - The value of intangible assets cannot be taxed directly or included in the value of taxable property;
- Section 100 (e) - When valuing taxable property, assessors may assume the presence of intangible assets that are necessary to put the taxable property to beneficial or productive use;
  - In Use Premise (Going Concern) v In Exchange (Salvage Value)
- Section 110 (f) - When the valuation includes (separable) intangible asset or includes income attributable to enterprise value (e.g., working capital), those values must be accounted for and removed.
  - Separable v. Inseparable Intangibles

HALF MOON BAY CASE

This case (May 2014) addresses intangible valuation theory in the assessment of the Ritz Carlton Half Moon Bay Hotel. The question at issue was “how to properly value taxable property, with associated intangible assets, at fair market value.” California Court of Appeals overturned Assessment Appeal Board and Trial Court that agreed with Assessor.

HALF MOON BAY CASE - CONTINUED

- Assessor Enrolled Value:

Sales Price:	$124,350,000
Personal Property:	$7,370,000
Taxable Real Estate Value:	$116,980,000

- Assessor Valuation:

Market Value:	$129,700,000
Personal Property:	$7,340,000
Real Estate:	$122,360,000
Enrolled at (within 5% of appraisal):	$116,980,000

- Property Owner Valuation:

Market Value (Purchase Price):	$124,350,000
Less Personal Property:	$8,000,000
Subtotal:	$116,350,000
Less Taxable Real Estate:	$99,500,000
Intangible Assets (goodwill and 3 others):	$16,850,000

HALF MOON BAY CASE - CONTINUED

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- The Assessor valuation deducted the management fee and the franchise fee in Income Approach which was assumed to address intangible value. (Management Fee Method).
- The Assessor attempted to discredit Assessor's Handbook (Sec. 502) which requires removal of intangible values in property assessments.
- Assessor relied on California Assessors' Association's position paper 99-003 rejecting the Assessors' Handbook. The California Assessors' Association does not agree with the Assessor's Handbook.

HALF MOON BAY CASE - CONTINUED

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- Taxpayer expert testified that intangible value is a residual.
- Taxpayer expert testified that the Management Fee Method does not capture all intangible values. Specifically did not address:

1.	Hotel work force in place:	$1,000,000
2.	Leasehold interest in a parking lot:	$200,000
3.	Agreement with golf course operator:	$1,500,000
4.	Goodwill:	$<u>14,150,000</u>
	Total:	$16,850,000

- Court ruled that method used by Assessor violated law as it did not remove all intangible items.
- Interestingly, ruling did not require assessor to recalculate goodwill, just workforce, parking leasehold and golf course agreement.

INTANGIBLE VALUE - LODGING PROPERTIES

- Why are cap rates higher for lodging than for traditional commercial real estate? An hypothesis is that the cap rate includes a return on intangible items.
- We can look at rates from PwC National Real Estate Investor Survey for 2nd Quarter (Korpacz):

Asset Type	Overall Rate
Full Service Hotel	7.73%
Regional Mall	6.60%
Power Center	6.65%
CBD Office	6.30%
Suburban Office	6.75%

- Reasonable rate is 7.75% for our subject full service hotel and 6.50% for other asset types.
- Note that a management fee is already deducted when the hotel cap rate is derived. Why is lodging cap rate higher?

INTANGIBLE VALUE - LODGING PROPERTIES

- We will need to know the required return for the intangible business operations.
- We can find the business cap rate from a business valuation resource. Operating hotel companies trade at 6 to 7 multiples of pre-debt EBITDA or cap rates of 14% to 16%. We will use 15%.
- With rates estimated, we can allocate percentage of value allocated to each component based on iteration of weighted rate.

Weighted Cap Rate:	Market		Iterated		Proof
Real Estate Rate:	6.50%	times	85.3%	=	5.54%
Business Rate:	15.00%	times	14.7%	=	2.21%
Going Concern Rate:	7.75%	times	100.0%	=	7.75%

INTANGIBLE VALUE - LODGING PROPERTIES

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- The property value can be allocated between real estate and intangible value.

Allocation:				
Hotel Real Estate:	$20,000,000	times	85.3%	$17,058,820
Intangible Value:	$20,000,000	times	14.7%	$2,941,180
Going Concern Value:		times	100.0%	$20,000,000

- The property was valued as a going concern for $20 million. Based on estimated rate of 7.75%, the NOI to going concern can be calculated:

Value Conclusion and Net Income:	
Hotel Going Concern Valued at:	$20,000,000
Cap Rate Used:	7.75%
Indicated NOI / EBIDTA:	$1,550,000

INTANGIBLE VALUE - LODGING PROPERTIES

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- If the NOI is $1.55 million, we can prove the allocation by capitalizing the income from each component.

Proof:	Value	Times	Rate	NOI
Net Income to Real Estate:	$17,058,820	times	6.5%	$1,108,823
Net Income to Intangible Assets:	$2,941,180	times	15.0%	$441,177
Total Net Income:	$20,000,000	times		$1,550,000

- One method of determining intangible value is the management fee which was deducted. The calculation below is based on a 20% net profit and 3% Mgt. expense.

Management Fees:		
Indicated NOI / EBIDTA:	$1,550,000	20%
Expenses including Management:	$7,750,002	80%
Total Gross Income:	$9,300,002	100%
Management Fees:	$279,000	3%

- Does deduction of $279,000 in management fees account for $2,941,180 of intangible asset value and $441,177 in net revenue to intangible assets?

CONCLUSIONS

- In most lending and property tax situations, the values of intangible items must be excluded or at least identified as a separate value from real property.
- Even though intangible items may exist, they may not add value to a going concern.
- If there are intangible items of value, there are numerous methods available to extract the value of intangible assets.

CONCLUSIONS

QUESTIONS?