

ONGOING CONCERNS OVER REAL ESTATE GOING CONCERNS

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Going Concern Valuation v. Business Valuation

Some basics:

- Both from a business appraiser's position and from the *real property appraiser's perspective* Going Concern Valuation is ***not business valuation.***
- The term & concept of Going Concern Valuation has been in the real property appraisers purview for decades.
- Going Concern from a business valuation perspective is a premise.
- Going Concern valuation from a real property appraisers perspective is different.

Going Concern Valuation v. Business Valuation

- ▶ **The difference is when the property is being appraised:**
- ▶ **When a business appraiser is appraising a business it is called a business valuation. Their appraisal may *(but may not)* include real estate.**
- ▶ **When a real property appraiser is appraising a property that has a business integrated with the real estate, such as a car wash, it is a going concern valuation that includes real estate.**

Going Concern Valuation v. Business Valuation

- ✓ R.P. appraisers **cannot** perform a going concern valuation if there is no business integrated within the real estate
- ✓ You **can** make a business valuation something less, (**no real estate**) but not a going concern valuation something less
- ✓ A *non*-operating car wash is a real property appraisal, if the business is operating it can be a going concern valuation

Yeah but . . . still, what is it about these two properties that make one be a going concern and the other not? how do you make the distinction?



How do you determine what properties are candidates for being a going concern????

Yeah but . . . still, what is it about these two properties that make one be a going concern and the other not? how do you make the distinction?



Discernment Rule 1

Physical Constraints

- ~ Does the real property have limited uses or is a single use?
- ~ Can the property accommodate different tenant types?

Yeah but . . . still, what is it about these two properties that make one be a going concern and the other not? how do you make the distinction?



Discernment Rule 2

Income Source

- ~ Is the property typically rented?
- ~ Is a business enterprise integral to generate income?
- ~ Are there lots of rent comps?
- ~ Is there market supported vacancy data?

NOTE: Rent vs. Revenue

Yeah but . . . still, what is it about these two properties that make one be a going concern and the other not? how do you make the distinction?



Discernment Rule 3

Distinct Identities

- ~ Does the business have a separate identity?
- ~ Is the business typically bought & sold with the real estate?
- ~ Is the property normally owned & operated as part of a business?
- ~ Is the sale data clear?

Yeah but . . . still, what is it about these two properties that make one be a going concern and the other not? how do you make the distinction?



Discernment Rules

- After applying these Rules, there should be no question what properties are candidates for going concern valuations

What you see is what you get . . .



strip center



self-serve car wash

if we compare a strip center to a self-serve car wash,
is the going concern idea more apparent in one than the other?

(no duh - dude)

how 'bout the FF&E?

Going Concern Valuation

The Problem:

- ▶ The problem is ***not*** valuing a going concern
- ▶ The problem ***is*** allocating a value to the components.
- ▶ This is especially true when attempting to value the intangible component.

Going Concern Valuation

The Bigger Problem:

- ▶ Moreover, the problem has been exacerbated *unnecessarily* because there are some real property appraisers who believe every real property has an intangible component.

That is just not true.

Going Concern Valuation

Because today is about litigation:

- ▶ **The American Society of Appraisers used to have an adage that asked:**

Value, can you prove it?

- ▶ **This is especially true for this topic**

Going Concern Valuation

- ▶ Value, can you prove it? Reason # 1
 - ▶ Far too long we have been *duped* into believing because the math is correct there must be value. That is simply not the case. Just because an appraiser can perform a mathematical formula, such as the Excess Earnings Method, they need to understand that if there is no market support for that conclusion then the math becomes a magical mathematical manipulation, and not a representation of market participants.

Going Concern Valuation

- ▶ Value, can you prove it? Reason # 1
- ▶ When we do this it becomes a *Theoretical Construct*.
- ▶ Which is an object (value) that is depended upon one's own mind without any empirical market evidence to support the theory,



Going Concern Valuation

- ▶ Value, can you prove it? Reason # 1
 - ❖ Whether the math is correct is not the question.
 - ❖ The question is what does it prove?
 - ❖ Is that a representation of what the market does?

*“Not from the market
then not in the report”*

- ▶ So how do real property appraisers prove a theory?

Going Concern Valuation

- ▶ Value, can you prove it? Reason # 1
 - ▶ How do we prove a theory?
 - ▶ **First, Pragmatic theory: Truth is verified and confirmed by the results of putting one's concepts into practice.**
How do R.P. appraisers do that?

the market



Going Concern Valuation

- ▶ Value, can you prove it? Reason # 1
 - ▶ How do we prove a theory?
 - ▶ Next, Correspondence theory emphasizes that true beliefs and true statements correspond to the actual state of affairs. What are the state of affairs for R.P. appraisers?
the market



Going Concern Valuation

- ▶ Value, can you prove it? Reason # 1
 - ▶ Correspondence theory centers heavily around the assumption that truth is a matter of accurately copying (*from the market*) what is known as "objective reality" and then representing it in thoughts, words and other symbols.

Not mathematical manipulations



Going Concern Valuation

- ▶ Value, can you prove it? Reason # 1
 - ▶ Next, scientific theory, is a well-substantiated explanation of some aspect of the natural world, based on knowledge that has been repeatedly confirmed through observation and experimentation
 - which in our case is the market*
 - ▶ Scientific Method, a method of inquiry must be based on empirical and measurable evidence (*from the market*) subject to specific principles of reasoning.

Going Concern Valuation

- ▶ Value, can you prove it? Reason # 1
 - ▶ A conjecture is a proposition that is unproven. Conjecture is contrasted by hypothesis (hence *theory, axiom, principle*), which is a testable statement based on accepted grounds.

In mathematics, a conjecture is an unproven proposition that appears correct

How do Real Property appraisers test a proposition?

The Market!

Going Concern Valuation

- ▶ Value, can you prove it? Reason # 1

Other notions:

- ▶ **spec·u·la·tive**: based on guesses or ideas about what might happen or be true *rather than on facts*



Going Concern Valuation

- ▶ Value, can you prove it? Reason # 2
- ▶ In appraising we are taught fundamental economic theory part of which states:
- ▶ That for value to exist there must be
 1. Demand
 2. Utility
 3. Scarcity
 4. **Transferability (actual sales)**

Going Concern Valuation

- ▶ Value, can you prove it? Reason # 2
 - ▶ Therefore, if one of these elements is missing there is *no* value.

We cannot abandon proven and accepted economic principles on which our profession is based, simply because ignoring it helps our cause!



Going Concern Valuation

- ▶ Value, can you prove it? Reason # 3
- ▶ There may not be an *applicable technique* and there may not be the *required data* to prove an intangible value exists.

To force the issue by misapplying a technique and not having the requisite market data but insisting that an intangible value be present *is tantamount to: arrogance or ignorance!* and quite possibly *negligent misrepresentation!*

Going Concern Valuation

- ▶ Value, can you prove it? Reason # 3
- ▶ *Negligent misrepresentation: A level of material misrepresentation includes a degree of carelessness, but goes a step further. That is when an appraiser makes statements or assertions in the appraisal report without any grounds for knowing whether they are true or not*

Going Concern Valuation

- ▶ Value can you prove it?

Appraisal Journal article April 1999

by Robert W. Owens, PhD

“When the business enterprise is inextricably tied to real estate, there may be no way to separate out of the business value in any truly defensible manner”



Going Concern Valuation

- ▶ **The appraisers conundrum?**
 - ▶ **The current problem is that federally related real estate transactions in the US choose to lend on the real estate only. They do not lend on the intangible**
 - ▶ **Neither does the SBA**
 - ▶ **Both require appraisers to remove the value of the intangible and personal property component from the going concern property value**

Going Concern Valuation

- ▶ The appraisers conundrum?

So what's an appraiser to do?

- ▶ FAQ 192: Question: I am valuing a controlling interest in a business enterprise by use of an asset-based (cost) approach, and that business owns real property. Am I required to have an appraisal of the real property or may I use other indications of the real property value?

Going Concern Valuation

- ▶ The appraisers conundrum?
- ▶ Response: An appraisal of the real property would not always be required. . . . For other intended uses, the business appraiser may determine that an indication of the real property value **other than a real property appraisal** may be appropriate. Such indications could be a management estimate, a recent transaction of the property, or tax assessment values.

Going Concern Valuation

- ▶ The appraisers conundrum?
 - ▶ Analyzing the effect on value might be appropriately made through the selection of comparable properties used in the sales comparison approach* or the deduction of certain line items of expense for management fees, maintenance or replacements in the income approach, for example.

***Sales of going concerns and sale lease-backs. Sale lease-backs most likely do not include the intangible**

Going Concern Valuation

- ▶ The appraisers conundrum?

So what's an appraiser to do?

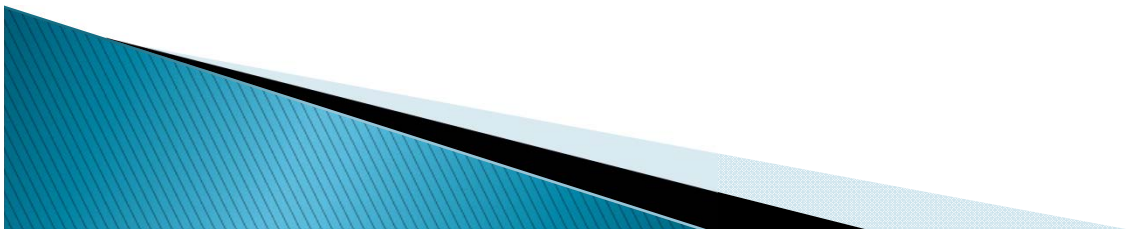
- ▶ **First,**

None are fail safe

None are universally adopted/approved

None are applicable always

There is no consensus for one method



Going Concern Valuation

▶ The appraisers conundrum?

So what's an appraiser to do?

- ▶ We are *stuck*. Banks know that a non-operating going concern is worth less than an operating property.

NOTE: THIS IS NOT LEGAL ADVICE

- ▶ I recommend giving them a going concern value and a go-dark value. They won't like it, but it is what it is.
- ▶ If that does not work, my advice is to use at least 2 procedures, to determine an amount and apply that amount to the component.

Going Concern Valuation

- ▶ The appraisers conundrum?

So what's an appraiser to do?

- ▶ **Do not** label the remainder (amount) “value.” **Do not** label it an “allocation” or “separation” as USPAP states those words are synonymous with appraisal.

- ▶ You could say something like:

“The remainder is attributable to the intangible”

- ▶ Then utilize an Extraordinary Assumption similar to that used when presenting the insurable value.

The *Client* requires the appraiser to value the real property only. The appraiser presented the total going concern value, and has allocated an amount for the FF&E. The appraiser did not value the intangible component. The Excess Earnings technique (*or whatever procedure(s) you choose*) has been utilized to arrive at a residual amount attributable to the intangible component. It is provided to aid in the overall decision making process of the client/reader/user, and no representations or warranties are made by the appraiser/reviewer regarding the credibility of this result. The use of this extraordinary assumption might have an effect on the assignment results.

Going Concern Valuation

- ▶ Just one more item if I may:
- ▶ Prof. William Kinnard asserted, “*it has long been held that any excess of contract rental over market rental is an intangible.*”
- ▶ This is a logical fallacy know as “*begging the question*” or “*self-evident truths*” i.e., “*everyone knows.*” “*it’s obvious*”

How long? Who held?

Going Concern Valuation Business Valuation vs. Real Estate Valuation

Why do I care?

- ▶ **You are in fact valuing a business.**
- ▶ **You may be testifying against a BV expert.**
- ▶ **Opposing attorney may be familiar with BV.**
- ▶ **Support your opinions/reasonableness check.**

▶ **Interesting assignments often have**

Going Concern Valuation Business Valuation vs. Real Estate Valuation

COMPARISON OF VALUE APPROACHES	
Business Valuation	Real Estate Appraisal
INCOME APPROACH	INCOME APPROACH
Discounted Future Earnings	Yield Capitalization
Capitalization of Earnings	Direct Capitalization
MARKET APPROACH	SALES COMPARISON
Guideline Public Company	N/A
Guideline M&A Company	Sales Comparison
ASSET APPROACH	COST APPROACH
Adjusted Net Asset	Cost Approach
Excess Earnings	N/A

Going Concern Valuation Business Valuation vs. Real Estate Valuation

Business Valuation Primer:

- ▶ **Types of business entities.**
- ▶ **Standards of value.**
 - **Premise of value (going concern vs. liquidation).**
- ▶ **Three approaches to valuation.**
- ▶ **Discounts and premiums.**
- ▶ **Goodwill and intangibles.**

Going Concern Valuation Business Valuation vs. Real Estate Valuation

Types of Business Entities:

- ▶ **Sole proprietorship**
- ▶ **Partnerships**
- ▶ **Limited Liability Company**
- ▶ **Corporation**
 - **C-Corporation**
 - **S-Corporation**

Going Concern Valuation Business Valuation vs. Real Estate Valuation

Standards of Value:

- ▶ **Fair Market Value (Similar to “Market Value”).**
- ▶ **Fair Value.**
- ▶ **Fair Value for Financial Reporting.**
- ▶ **Investment Value.**
- ▶ **Intrinsic Value.**

Going Concern Valuation Business Valuation vs. Real Estate Valuation

Revenue Ruling 59–60:

- ▶ **Nature of the business and history of the enterprise.**
- ▶ **Economic outlook in general and the condition and outlook of the specific industry in particular.**
- ▶ **The book value of the stock and the financial condition of the business.**
- ▶ **The earning capacity of the company.**
- ▶ **The dividend paying capacity.**
- ▶ **Whether or not the enterprise has goodwill or other intangible value.**
- ▶ **Sales of the stock and size of the block of stock to be valued.**
- ▶ **The market price of the stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.**

Going Concern Valuation Business Valuation vs. Real Estate Valuation

Approaches to Valuation:

- ▶ **Asset Approach**
- ▶ **Income Approach**
 - **Discounted Future Cash Flow (Earnings) Method**
 - **Capitalization of Cash Flow (Earnings) Method**
- ▶ **Market Approach**
 - **Guideline Public Company Method**
 - **Guideline Merger & Acquisition Method**

Going Concern Valuation Business Valuation vs. Real Estate Valuation

Asset Approach:

- ▶ **Adjusted Net Asset Value Method**
 - Asset accumulation method
 - Adjust all assets to FMV net of liabilities

- ▶ **Excess Earnings Method**
 - ARM 34/Rev. Ruling 68-609 (last resort method)
 - Capitalize earnings above a reasonable return on tangible assets

Going Concern Valuation

Business Valuation vs. Real Estate Valuation

Income Approach – Discounted Cash Flow:

- ▶ **Determining future cash flow**
 - Normalization adjustments
- ▶ **Measures of earnings and cash flow**
 - Net Cash Flow
 - EBT
 - EBIT
 - EBITDA

Going Concern Valuation Business Valuation vs. Real Estate Valuation

Income Approach – Discounted Cash Flow:

- ▶ **Discount Rates/Cost of Capital**
 - **Measure of risk applied to economic benefit**
 - **Cost of Equity**
 - **CAPM, Build-up, Fama-French, Arbitrage Pricing**
 - **Weighted Average Cost of Capital (WACC)**
 - **Similar to Band of Investment**

Going Concern Valuation Business Valuation vs. Real Estate Valuation

Income Approach – Capitalization:

- ▶ **Determining single-period cash flow**
 - Similar normalization adjustments, stable cash flow

- ▶ **Capitalization rate**
 - Discount rate minus estimated future growth



Going Concern Valuation Business Valuation vs. Real Estate Valuation

Market Approach – Guideline Public Company:

- ▶ Use publicly-traded company data to value private.
- ▶ Large population and great data availability.
- ▶ Rev. Ruling 59-60 advocates.
- ▶ Must find “same or similar” businesses.
- ▶ Minority interests.

Going Concern Valuation Business Valuation vs. Real Estate Valuation

Market Approach – Guideline M&A Company:

- ▶ **Ownership transfers of controlling interests.**

- ▶ **Use multiple transaction databases:**
 - Pratt's Stats

 - Bizcomps

 - Public Stats

 - IBA Database

◦ Mergerstat

Going Concern Valuation Business Valuation vs. Real Estate Valuation

Market Approach – Guideline M&A Company:

- ▶ **Understand databases & limitations of data.**
 - **FMV vs. Investment Value**
 - **MVIC vs. Equity**
 - **Duplicate transactions**
 - **Relevant timeframe**
 - **Details of sale – stock vs. asset, earnouts, what was included?**

Going Concern Valuation Business Valuation vs. Real Estate Valuation

Other Valuation Methods (examples):

- ▶ **Prior Transactions**
- ▶ **Offers**
- ▶ **Buy-Sell Agreements**

Going Concern Valuation Business Valuation vs. Real Estate Valuation

Discounts and Premiums:

- ▶ **Minority versus control.**
- ▶ **Lack of marketability.**
- ▶ **Other discounts:**
 - **Key person, blockage, voting, trapped-in capital gains, etc.**



Going Concern Valuation Business Valuation vs. Real Estate Valuation

Goodwill and intangibles:

- ▶ Goodwill as a residual concept.
- ▶ Intangibles are part of overall goodwill/goodwill is an intangible.
- ▶ What are intangibles?
 - Nonphysical factors (Brookings Task Force).
 - Arising from: Rights; Relationships; Grouped Intangibles; or Intellectual Property (International Valuation Standards).
 - ...assets (not including financial assets) that lack physical substance (FASB).

Going Concern Valuation Business Valuation vs. Real Estate Valuation

Intangible assets:

- ▶ **Segmented into Five Basic Categories:**

- 1. Marketing-related (trademarks, trade names).**
- 2. Customer-related (lists, relationships).**
- 3. Artistic-related (plays, books, music, pictures).**
- 4. Contract-based (licensing, royalties, leases, use rights).**
- 5. Technology-based (patents, domain names, data, formulas, processes, recipes).**

Going Concern Valuation Business Valuation vs. Real Estate Valuation

Takeaways:

- ▶ **Business & real estate valuation have many similarities and differences.**
- ▶ **Going concern real estate appraisers should be knowledgeable on BV issues.**
- ▶ **This presentation isn't enough!**
 - **Each of the topics above is its own multi-day class.**