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HYDE Valuations, Inc.

We Value Both Real Estate and Businesses
Including Machinery & Equipment

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Appraisal Problems

Merry Christmas!



People make mistakes, oversights happen, and appraisers do not always agree. Over the past several years we have performed numerous appraisal reviews of other appraisers' work and were asked to identify errors (if any) that the appraiser might have made. Sometimes we find errors in these reports, and sometimes we do not. Occasionally we have found that an appraiser has determined a completely different conclusion than we would have given the same data, or performed their analysis in a manner that is unusual when compared to our methodologies. However, it important to stress here that there is a major difference between an error and a difference of opinion in an appraisal. Appraisals, just like appraisers, are all different, and we all interpret data differently. This is not to say that any time appraisers have differing conclusions that both are valid, however. Errors are sometimes commonplace, and they can often be fairly easy to identify.

In a real estate appraisals, it is often quite common to find errors in the income approach section of an appraisal report - especially where the subject property involves a significant business component (such as in hotels or assisted living facilities). The problem stems from the selection of an appropriate capitalization rate. The size of the selected cap rate is based on how risky the subject investment is - where risk is associated with the likelihood that the subject income stream will continue; increase, decrease or perhaps go away altogether. In an investment property where the sole income stream is a lease to a third party, the risk of that income stream continuing can be measured by analyzing other properties similar to the subject and their rental rates. If the rents are similar, than it is likely that the income stream will continue. If the subject rents are higher than those of competing properties, then naturally the risk to the income stream is considerable. If the subject rental rates are lower than those of competing properties then one could therefore conclude that there is very minimal risk to the income stream. If the subject property is a hotel, an assisted living facility, a mini-storage facility, a landfill, or any other type of business where the real estate is an operating asset of the business then the risk of the subject income stream continuing increases by a considerable margin since the success or failure of the business is a key component. In such a scenario, the appraiser has to deal with questions such as: "How successful is the subject as compared to its industry?" "Are there any specific risk factors that apply to the subject in addition to those generally weighted?" "How is the income stream expected to vary over the next few years?" These complications can, and very often do, lead to errors in an appraisal report. If an appraiser uses a cap rate within the range usually associated with properties that only have a lease income to value a property that is an operating asset of a business, then the

property will likely have been overvalued – a mistake which can be fairly easy to catch, but at the same time often has a HUGE impact on the determined market value conclusion!

Similar to real estate appraisals, in business appraisals some of the most common errors tend to involve the income approach. For example, in business appraisals there are several different income based methods that each require a different level of income stream to use in the appraisal. There are also various methods for calculating discount rates. Problems can, and often do, occur when an appraiser calculates an income stream and discount rate that were not designed to be used together. For example: if a discount rate calculated by use of a build-up method using rates from public markets is applied to a net income, EBITDA, or any pretax income stream, the valuation conclusion will be wrong. This method of determining a discount rate requires the appraiser to develop the income stream that best approximates the dividend paying capacity of the company - which is itself another error that is commonly made! Appraisers often seem to skip a step or two in the calculation of the dividend paying capacity during the course of performing a business appraisal, and this oversight will generally result in an overvaluation of the business.

One difference of opinion that we have with some other appraisers is the applicability of the guideline public company method when used to appraise a small business. Some appraisers believe they can determine multiples from an analysis of such companies as Albertson's, Safeway, and Wal-Mart; and then apply these valuation multiples to a community grocery store. They base their reasoning on the fact that all of the comparable companies operate in the same industry – which happens to be true. However, despite this being a factual opinion, it is not typically the way that we would perform our analysis as it is our opinion that the size differential, the ability to obtain capital from various sources, and the geographic diversity that these large companies enjoy make them unsuitable as comparable companies for a small grocery store that has only one location, a limited customer base, and very limited capital sources. Trying to adjust for the differences between a huge public company and a small privately held company can produce very strange results.

Errors can be caught and can be corrected. Opinions and differing methodologies can be identified and respected for what they are. Being able to determine the difference between them is an essential aspect of appraisal reviews.

Valuations play a part in all strategic transactions, tax, and many litigation matters. For additional information or advice on a current situation, please do not hesitate to call. **We value real estate, businesses, and personal property including livestock and machinery & equipment.**

Sincerely,



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Enrolled to Practice Before the IRS (Enrolled Agent)
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