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HYDE Valuations, Inc.

We Value Both Real Estate and Businesses
Including Machinery & Equipment

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Real Estate Oriented Businesses

Appraisals of real estate oriented businesses cause some unique problems for many appraisers. Examples of these types of businesses include such things as hotels, convalescent hospitals, assisted living facilities, truck stops, feed lots, dairies, and convenience stores.

Since real estate is involved, most business appraisers are not licensed to appraise the underlying assets of these entities as a real estate appraiser license is required to appraise real estate. However, most real estate appraisers lack the training and expertise to value businesses since they involve entirely different risks, require a more in-depth analysis, and the data for discount and capitalization rates apply to net cash flow, not net operating income as is typical in real estate appraisals. There is a big difference in the value of a well-run, well-located, real estate oriented business versus a poorly run real estate oriented business; very similar to the difference in profitable versus unprofitable businesses of other types. Most real estate appraisers are unequipped and do not possess the required training and expertise to value businesses, including those that are real estate oriented.

A recent appraisal assignment in which I am valuing approximately forty assisted living facilities has made this problem very clear. My assignment is to estimate the value of the real estate, determine market lease rates for the real estate "as if" leased from an independent third party (even though they are actually owned by related entities), and value the business entities that operate the assisted living facilities. As part of the assignment, I was furnished with real estate appraisals that valued each facility as a real estate oriented business done by ten different appraisal companies for each of the forty assisted living facilities. There were a lot of "interesting" methodologies employed by the ten appraisal companies, however the following was the most interesting:

The appraisers valued the property and business using the sales comparison approach and income approach, based on data for operating assisted living facilities, concluding at a value for the combined real estate and business values. In order to allocate the concluded value between the real estate, the furniture, fixtures, and equipment and the intangible business value (going concern value) they compared the property to an apartment complex and used a 7.5% cap rate for apartments and divided it by their concluded 11.5% cap rate for assisted living facilities (with the business) and arrived at 65% which they claim represents the value of the real estate alone. They called the balance of the value a mixture of furniture, fixtures and equipment and going concern value. They estimated the value of the furniture, fixtures and equipment at 65% of cost meaning that it was approximately 35% depreciated. They further claimed to have checked the business component value by estimating a professional management fee of 15% (they used fees from 10% to 30% rather arbitrarily) and dividing it by their concluded business value conclusion arriving at a business cap rate between 11% and 15% which they called reasonable as it was about 30% to 45% of the assisted living facility's payroll expense which they stated was supported in the Business Reference Guide, a source of rules of thumb for business brokers.

The following shows how this worked on a specific property. This assisted living facility is a 4,000 square foot, average quality construction, wood framed structure (basically a house) on one-third of an acre built fifteen years ago in average condition.

The real estate appraiser concluded at a total enterprise value of $1,540,000 and using their allocation formula decided that the real estate was worth $1,000,000, the FF&E was worth $35,000 and the balance was the intangible business value. The real estate appraiser did not value the land or do a cost approach which would have given them a better idea of the real estate value.

Using a typical cost approach with data from Marshall Valuation Service, I determined that the replacement cost new for this type of property is about $80 per square foot. The land is assessed by the county assessor for $85,000 – let's assume that it is worth $100,000. The replacement cost for the building brand new would be about $370,000 plus site improvement costs of another $30,000. The land and building cannot be worth more than $500,000 as that is the value of a brand new similar building and the value of the land. After subtracting some amount for wear and tear, the value of the real estate is about $435,000.

Due to the way the real estate appraiser allocated the value, their conclusion for the real estate was over twice what it could even feasibly be based on its replacement cost! This example demonstrates the need to use appraisers that are trained and qualified to value these special types of properties.

The proper way to value a real estate oriented business is to value the real estate alone, compute and support a market value lease rate "as if" leased from an independent third party, include the imputed rent expense as an expense to the business, value the business using proper business appraisal techniques and methodologies, and then add the market value of the real estate to the fair market value of the business to arrive at the value of the real estate oriented business. This process requires either a real estate appraiser and a business appraiser working together, or an appraiser that wears both hats…as we happen to do.

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,

Paul R. Hyde, EA, MCBA, ASA, MAI
Enrolled Agent – Enrolled to Practice Before the IRS
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Accredited Senior Appraiser – Business Valuations
Designated Member – Appraisal Institute (MAI)
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