



**THE INSTITUTE OF BUSINESS APPRAISERS, INC.**

# Business Appraisal Practice

*In  
this  
Issue*  
\*

Editor's Column – Valuing Businesses with Real Estate Components

*Paul R. Hyde, EA, MCBA, BVAL, ASA*

Strangi II Revisited: Homerun for the Taxpayer!

*Carl Lloyd Sheeler, Ph.D., CBA, AVA*

Calculating the WACC for Private Companies

*Richard M. Duvall, Ph.D., CFA, CBA, CPCU and  
Laroy W. Wolff, Jr., CPA/ABV, ASA, CVA, CMA, CFE*

Public and Private Capital Markets are Not Substitutes

*Robert T. Slee, CBA*

Overcome Your Natural Biases

*Sherry C. Smith, CBA, BVAL, MBA*

SEC Staff Accounting Bulletin 101 and Valuation Analysis:  
When is Revenue Not Revenue

*Robert W. Laversin, CPA/ABV, CBA, ASA*

Dental Practice Valuation: Managed Care Factor

*Gary R. Clinton*

Book Reviews for Business Appraisers: *The Handbook of  
Business Valuation and Intellectual Property Analysis*

*Shawn M. Hyde, CBA*

You Are Not Alone

*Rand M. Curtiss, MCBA, FIBA, ASA, ASA*

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## Editor's Column— Valuing Businesses with Real Estate Components

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*Paul R. Hyde, EA, MCBA, ASA, BVAL*

Problems occur in both business and real estate appraisals when an appraiser uses a capitalization rate applicable to one for the other. I made this mistake as a brand new business broker many years ago. I was used to seeing a capitalization rate of ten percent or so for income producing real estate properties, i.e. commercial buildings, apartment buildings, etc., and used that rate to estimate a listing price for my very first business opportunity listing. Needless to say, the business did not sell. I soon learned that there is a big difference between the way income producing real estate properties and small operating businesses are viewed even if they are combined.

The following are the three options available along with the values they generate based on the example included later in this article:

A real estate capitalization rate is used to value a business, even if it includes some real estate.

\$1,667,000 Enterprise Value

This results in an over valuation of the business enterprise. As shown in the example, there is a significant difference in a typical business pre-tax income capitalization rate and a typical real estate capitalization rate applicable to pre-tax net operating income.

A business capitalization rate is used to value a business including real estate as an operating asset.

\$333,000 Enterprise Value

This results in an under valuation of the business enterprise. The typical business capitalization rate, even on a pre-tax equivalent basis, is significantly higher than the typical real estate capitalization rate.

The real estate owned by a business is valued as real estate, a market lease rate is included in the business expenses, the business is valued using a business capitalization rate, and the enterprise value is obtained by combining the real estate and business value.

\$707,000 Enterprise Value

This is the correct way to value the enterprise. It uses the appropriate business capitalization rate for the business entity portion of the income stream and the appropriate real estate capitalization rate for the real estate portion of the income stream.

First, the rates shown below are assumed for the example:

## Editor's Column – Valuing Businesses with Real Estate Components

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Discount Rate from Build-Up Method	20%
Long-Term Sustainable Growth Rate	3%
Capitalization Rate	17%

Real Estate Capitalization Rate Extracted from the Market	9%
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Second, the income forecast for ABC Company is presented:

### ABC Company Forecast

Revenue	1,000,000
Cost of Goods Sold	400,000
Gross Profit	600,000
Operating Expenses	
Salaries Etc.	100,000
Other Expenses	350,000
Total Expenses	450,000
Pre-Tax Net Income	150,000
Income Tax	60,000
Net Income	90,000
Depreciation	75,000
Capital Expenditures	(50,000)
Changes in Working Capital	(35,000)
Changes in Long-Term Debt	(25,000)
Net Cash Flow to Equity	55,000

Included in the company's assets is the real estate owned by the company that is considered an operating asset. For simplicity, it is assumed that there is no loan against the real estate.

Third, the value of the enterprise using the real estate capitalization rate is illustrated:

#### Enterprise Value Using Capitalization Rate Applicable to Real Estate

Pre-Tax Net Income	150,000	=	
Real Estate Capitalization Rate	9%		1,666,667
Value of the Enterprise (Rounded)			1,667,000

## Editor's Column – Valuing Businesses with Real Estate Components

Fourth, the value of the enterprise using the business capitalization rate on both a net cash flow and an equivalent rate using a pre-tax income stream is shown:

### Enterprise Value Using Capitalization Rate Applicable to Net Cash Flow

Forecast Net Cash Flow to Equity	55,000		
Times: Long-Term Sustainable Growth Rate	1.03		
Net Cash Flow Applicable to the Future	<u>56,650</u>		
Net Cash Flow Applicable to the Future	56,650	=	333,235
Capitalization Rate to Net Cash Flow	<u>17%</u>		
Value of the Enterprise (Rounded)			<u><u>333,000</u></u>

### Enterprise Value Using Capitalization Rate Applicable to Pre-Tax Income

Pre-Tax Net Income	150,000		
Times: Long-Term Sustainable Growth Rate	1.03		
Pre-Tax Net Income Applicable to the Future	<u>154,500</u>		
Pre-Tax Net Income	154,500	=	333,235
Capitalization Rate	<u>46.4%</u>		
Value of the Enterprise (Rounded)			<u><u>333,000</u></u>

Fifth, the appropriate method of valuing a mixed enterprise is illustrated:

### **ABC Company Forecast**

Revenue	1,000,000
Cost of Goods Sold	<u>400,000</u>
Gross Profit	600,000
Operating Expenses	
Salaries Etc.	100,000
Real Estate As If Leased	50,000
Other Expenses	<u>350,000</u>
Total Expenses	500,000



**Editor's Column – Valuing Businesses with Real Estate Components**

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Pre-Tax Net Income	100,000
Income Tax	<u>40,000</u>
Net Income	60,000
Depreciation	75,000
Capital Expenditures	(50,000)
Changes in Working Capital	(35,000)
Changes in Long-Term Debt	<u>(25,000)</u>
Net Cash Flow to Equity	<u><u>25,000</u></u>

Value of the Real Estate Owned by the Company

Real Estate Rent	<u>50,000</u>	=	
Capitalization Rate	9%		555,556

Value Using Capitalization Rate Applicable to Net Cash Flow

Forecast Net Cash Flow to Equity	25,000		
Times: Long-Term Sustainable Growth Rate	<u>1.03</u>		
Net Cash Flow Applicable to the Future	25,750		
Net Cash Flow to Equity	<u>25,750</u>	=	
Capitalization Rate	17%		151,471
Add: Value of Real Estate			<u>555,556</u>
Value of the Enterprise (Rounded)			<u><u>707,000</u></u>

It should be noted that business appraisals grow the forecasted income stream by one year using the sustainable long-term growth rate in order to be representative of what is expected long-term including an eventual sale of the business. The capitalization rate used in the business appraisal is the discount rate, often developed using the build-up method, less the long-term sustainable growth rate.

Real estate appraisers are trained to observe capitalization rates in the market and to extract the capitalization rate for the subject property from the market. In order to do this, they typically examine sales of very similar properties comparing the net operating income to the sales price for indications of the appropriate rate. Real estate appraisers are careful to use only properties for which the net operating income was calculated the same way. For example, it would be inappropriate to use the net operating income for a property that deducted as an expense reserve

allowances for a new roof, replacement of appliances, and other such capital expenditures to value a property using an income stream without a replacement allowance. Other differences in comparable properties must also be adjusted for using market data before capitalization rates can be extracted and used to value a subject property. Because the real estate capitalization rates are extracted directly from the market, they do not need to be grown by a year nor modified for long-term growth as are the business capitalization rates. Included in the real estate capitalization rate is the market's perception of all future cash flows from the property including its eventual sale.

The following illustrates the same company with an operating expense adjustment to deduct the market value rental rate for the real estate owned by the business in determining the value of the business. The real estate appraiser determines the both the value of the real estate and the appropriate market rental rate using a capitalization rate applicable to the real estate portion of the income stream. The enterprise value is determined by combining the value of the real estate and the business.

The large difference in the capitalization rate applicable to pre-tax net income compared to the rate applicable to the real estate illustrates the typical difference in risks associated with many business enterprises and real estate income properties.

Real estate properties incur vacancies, tenants that may not pay, etc. however, there is typically a good chance that the property can be resold for a substantial sum whether or not it meets the forecasted income expectation. In other words, it is likely that an investor in income producing real estate can obtain at least a large portion of the amount originally invested if not that plus a return on the investment. Of course, investors sometimes lose properties to foreclosure or other problems because of a variety of circumstances, but, ignoring problems associated with how the investment is funded, the risk of the original investment being returned to the investor is often much lower with income producing real estate than with an operating small business.

Business appraisers simply do not have the needed data to extract capitalization rates directly from the market. Some appraisers use the inverse of market multiples such as Price to Earnings as indications of capitalization rates. however, rarely does sufficient information about the comparables exist so that the degree of difference between the comparables and the subject can be determined. Due to the lack of very similar sales about which sufficient data is available, business appraisers must use some other method to mirror the market with respect to risk of the forecasted income stream. A build-up method is commonly used.

Whichever method is used to develop a capitalization rate, it should be understood that the rate when applied to the chosen income stream should be representative of all future cash flows associated with the investment. In real estate, what is called the reversion (the realization of proceeds from an eventual sale) is accounted for in the capitalization rate including any anticipated appreciation in value. The theoretical concept is similar for the business appraisal capitalization rate – when applied to the chosen income stream, it too reflects the value of all future cash flows associated with the investment. However, it must include the often higher

## **Editor's Column – Valuing Businesses with Real Estate Components**

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risk associated with the return on investment or even that the actual investment may not be returned at all.

When valuing enterprises that contain both a real estate and a business component, special care must be taken to correctly identify each component and use appropriate risk rates applied to the correct level of income stream.

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