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# Business Appraisal Practice

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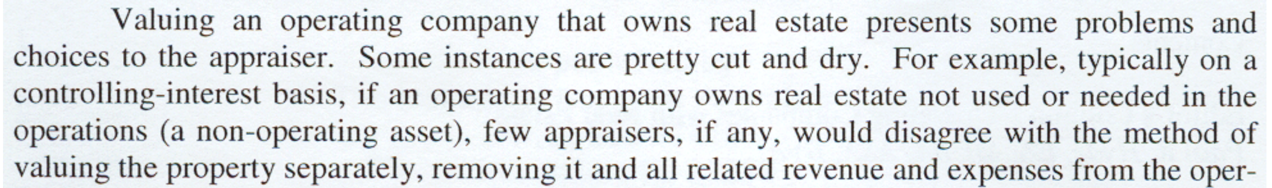
# Editor's Column
# Operating Companies with Real Estate

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


Valuing an operating company that owns real estate presents some problems and choices to the appraiser. Some instances are pretty cut and dry. For example, typically on a controlling-interest basis, if an operating company owns real estate not used or needed in the operations (a non-operating asset), few appraisers, if any, would disagree with the method of valuing the property separately, removing it and all related revenue and expenses from the oper-

Second, capacity issues must be addressed. Has the company outgrown the space? Or is it likely to do so in a relatively short period of time? If capacity is an issue, how this will be resolved and the associated costs should be built into the appraiser's forecast.

Third, depending on the nature of the business, things like anticipated traffic pattern changes, road construction work, road widening plans, etc. may be important. I have recently appraised several businesses that had huge impacts from extended road construction work which made access to their business locations very difficult for a year or more. Several retail businesses have recently gone out of business in Eastern Oregon as a direct result of the highway department installing a concrete median in the center of the main road in town prohibiting left turns into businesses that had been accessed this way for over twenty years.

**Real estate is leased from a related entity or individual**

This configuration is quite commonly found in the appraisal of closely held interests. Often, the rental rate is considerably above or below "market" rental rates. When valuing a control interest, many business appraisers adjust the actual rent paid to a rate representative of what an outside, independent landlord would charge, i.e. a "market rental rate." While this is appropriate, the additional issues discussed above may need to be considered as well.

The estimate of a market rental rate is obtained from a variety of sources. The best source, in my opinion, is from a current real estate appraisal of the property. Included in most commercial real estate appraisals is the market rate used by the appraiser in his or her income method. As a practical matter, many companies cannot afford or are unwilling to spend the amount necessary to obtain a real estate appraisal. In these cases, I typically call several real estate appraisers that I often work with on other matters and ask them their opinion of a reasonable rental rate for the type and location of the property in question. If both of these first two methods are not an option, the business appraiser could check with commercial real estate brokers (those firms that commonly lease property are best) for estimates or as a last resort, they could do their own rental survey.

**Real estate is owned by the operating company**

This configuration may be more challenging. Some business appraisers consider real estate owned by the company as an operating asset and make no adjustments to the income stream. This is certainly an option. However, I find this option troublesome. There are some businesses where real estate is an integral part of the business, for example, motels and hotels, storage rental units, etc. However, for the most part, businesses that could be operated from another location are better treated as if they are separate from the real estate.

When appraising a controlling interest, I typically remove the real estate owned by the operating company and make adjustments necessary to reflect the property as if it were leased from an independent third party at market rates. I then value the company based on an adjusted income stream as if the property were leased and add the value of the property to the value of

the company to obtain the value of the business entity. This means that if the property is covered by a mortgage, I remove the loan and add back the associated interest expense before subtracting a "market" lease rate for the property. Depreciation allocated to the real estate should also be adjusted and separated from depreciation for the operating assets.

Not making this adjustment may significantly undervalue the company's stock. Consider the following example:

The company owns real estate used in the business with a book value of $750,000 but with a current fair market value of $2,000,000. If the real estate were leased from an independent, third party, the real estate appraiser has indicated that the market triple net lease rate would be $200,000. A $250,000 loan is owed against the property.

The following chart illustrates the two methods of valuing the business using a capitalization of earnings method:

**Balance Sheet**

| | |
|---|---|
| Current Assets | 250,000 |
| Real Estate - Cost | 750,000 |
| Less: Accumulated Depreciation | -375,000 |
| Other Fixed Assets - Net | 3,000,000 |
| Total Assets | 3,625,000 |
| | |
| Current Liabilities | 100,000 |
| Real Estate Mortgage | 250,000 |
| Other Long-Term Liabilities | 1,000,000 |
| Total Liabilities | 1,350,000 |
| Net Worth | 2,275,000 |
| Total Liabilities & Net Worth | 3,625,000 |

**Assumptions:**

Real Estate - Fair Market Value of $2,000,000

Real Estate - Fair Market Lease Rate $200,000 per year

Real Estate - Depreciated over 20 years -- straight line

Discount Rate of 20%

Sustainable Long-Term Growth Rate of 3%

As this chart illustrates, there is a significant difference in the value of the company's

**Real Estate Treated as an Operating Asset**
**Income Forecast**

| | |
|---|---|
| Revenue | 5,000,000 |
| Expenses: | |
| Total Operating Expenses | 4,000,000 |
| Interest on Mortgage | 20,000 |
| Net Income Before Taxes | 980,000 |
| Provision for Income Taxes-40% | 392,000 |
| Net Income | 588,000 |
| Add: Depreciation on Building | 37,500 |
| Add: Business Depreciation | 400,000 |
| Less: Capital Expenditures | -250,000 |
| Changes in Working Capital | -150,000 |
| Changes in Long-Term Debt | -87,000 |
| Net Cash Flow | 538,500 |

**Real Estate Treated as if Leased from 3rd Party**
**Income Forecast**

| | |
|---|---|
| Revenue | 5,000,000 |
| Expenses: | |
| Total Operating Expenses | 4,000,000 |
| Real Estate Lease (Triple Net) | 200,000 |
| Net Income Before Taxes | 800,000 |
| Provision for Income Taxes-40% | 320,000 |
| Net Income | 480,000 |
| Add: Depreciation on Building | - |
| Add: Business Depreciation | 400,000 |
| Less: Capital Expenditures | -250,000 |
| Changes in Working Capital | -150,000 |
| Changes in Long-Term Debt | -85,000 |
| Net Cash Flow | 395,000 |

| Capitalization of Earnings Method: | | | Capitalization of Earnings Method: | | |
|---|---|---|---|---|---|
| Forecasted Net Cash Flow | 538,500 | | Forecasted Net Cash Flow | 395,000 | |
| Forecast Growth | x 1.03 | | Forecast Growth | x 1.03 | |
| Estimated Future Income | 554,655 | | Estimated Future Income | 406,850 | |
| | | | | | |
| Estimated Future Income | 554,655 | | Estimated Future Income | 406,850 | |
| Capitalization Rate (20% - 3%) | 0.17 = | 3,262,676 | Capitalization Rate (20% - 3%) | 0.17 | = 2,393,235 |
| Estimated Value of Company | 3,262,676 | | Estimated Value of Company | 2,393,235 | |
| Add: Value of Real Estate | N/A | | Add: Value of Real Estate | 2,000,000 | |
| Less: Mortgage | N/A | | Less: Mortgage | -250,000 | |
| Estimated Value of Stock | **3,262,676** | | Estimated Value of Stock | **4,143,235** | |

stock based on which approach is used.

The key question to ask is: Would a hypothetical willing buyer and a hypothetical willing seller consider the current fair market value of the real estate or would they simply consider it an operating asset and not make any adjustments?

Based on my twenty-three years experience as a business broker, I believe that both buyers and sellers will and do consider the value of the real estate owned and used by the business separately from the value of the business itself.

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Please submit articles for *Business Appraisal Practice* by email to: prh@hydebpv.com.