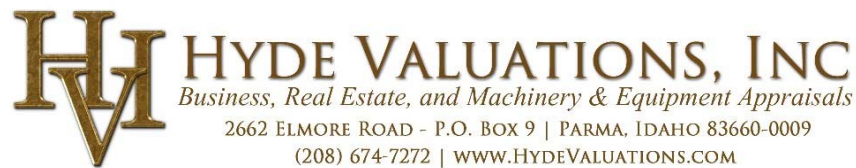




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The Value of Leasehold Improvements

Determining the value of leasehold improvements can be tricky – the only answer that always applies when valuing leasehold improvements is “it depends.” Some of the critical factors that must be considered are:

- The value to whom? Landlord or Tenant?
- What is the remaining term of the lease?
- How likely is it that the leasehold improvements can and will be used by another tenant?
- Are the leasehold improvements critical to the operation of the business in place?
- Can the lease be renewed? If so, at market or at some specified amount?
- Are the leasehold improvements really trade fixtures and does the tenant have the right and/or obligation to remove them at the end of the lease?
- Is the tenant having financial problems? Can the tenant continue paying the lease though the maturity of the lease?
- What does the lease say about the leasehold improvements/trade fixtures?

It is not unusual for a new restaurant to spend a lot of money installing interior walls, equipment, furniture, decorations, and other fixtures that contribute to the desired atmosphere of the business. At the end of the lease, or much earlier in the case of a failed restaurant, the money spent on leasehold improvements may have little, if any, value. In a similar fashion when a dentist takes new generic office space and installs significant electrical, plumbing, interior walls, cabinets, and equipment, the space is no longer useful to many other tenants without significant alterations.

Leasehold Improvements are improvements made by a tenant or by a landlord on behalf of a tenant to real property. Typically, at the end of the lease, the leasehold improvements become the property of the Landlord. Tenant Improvements (TIs) are the same as leasehold improvements, however, they are often called tenant improvements at the beginning of a lease period. Generally, the tenant is given a certain allowance towards the cost of building out the tenant improvements or the landlord may build them for the tenant. The costs of the tenant improvements are recovered by the landlord over the period of the lease and are typically accounted for in developing the lease rate. If a tenant defaults on the lease, the landlord can suffer a significant loss as many tenant improvements are specific to the tenant and must be replaced or greatly modified before the property can be leased to another tenant.

When leasehold improvements are made by the tenant, they are typically shown as an asset on the tenant’s balance sheet. Depending on the nature of the business, the amount expended on leasehold improvements can be substantial. Leasehold improvements are amortized, often over the term of the lease, however, the amount shown on the company’s books as the net cost of leasehold improvements rarely is representative of its actual fair market value. When evaluating a company’s assets and liabilities in a cost or asset approach, many appraisers give little thought to the sometimes very large amount shown for leasehold

improvements. If the company were liquidated, often the leasehold improvements will return no value at all as they typically become part of the real estate and thus belong to the landlord.

The value of leasehold improvements is highly dependent on the remaining term of the lease and the benefit to the tenant of the leasehold improvements during the lease. Generally, the shorter the remaining term of the lease, the less value associated with leasehold improvements. Often the value of leasehold improvements to the tenant is zero or a nominal amount. However, if the lease contains a provision requiring the tenant to restore the premises to the “before” conditions, the leasehold improvements could have a negative value representative of the costs to restore the property.

Fixtures or Trade Fixtures are personal property items owned by the tenant that are placed in or attached to leased real estate by a tenant to help carry out the trade or business of the tenant. Typically, a fixture when attached to real property becomes part of the real estate. A Trade Fixture, on the other hand, typically remains personal property even with attached to the real estate. There is often a disagreement between tenants and landlords as to what is a fixture, i.e. real property belonging to the landlord and what is a trade fixture, i.e. personal property that may be removed by the tenant. Lenders that lend on fixtures or trade fixtures generally demand that the landlord sign a Landlord Waiver confirming that the collateral is personal property belonging to the tenant so that they can remove the collateral if the tenant defaults on a loan. If a major asset is considered a trade fixture by the tenant and shown on their balance sheet, the possibility that it is considered a fixture by the landlord should be explored. Documentation should be available and reviewed by the appraiser to clarify the asset’s nature. Should such documentation not be available, problems will likely result when the tenant attempts to remove the asset in question at the end of the lease. The appraiser, particularly when using a cost or asset approach, must be careful not to consider such an asset as a trade fixture belonging to the tenant unless it can clearly be established that such is the case. Typically, in a dispute between a tenant and a landlord, items that have been attached in a permanent type nature will likely be considered to belong to the landlord as a tenant or leasehold improvement rather than as a trade fixture.

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.**



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