nyrej

Total assets of business vs. real estate value trends - by John Rynne

March 24, 2020 - Spotlights

Over my years in the appraisal field, one of the areas of confusion between appraisers and their clients are property types that have businesses highly connected to the real estate. There is a trend by clients to not necessarily want just the real estate value. This is primarily for properties such as hotels, motels, nursing homes, assisted living projects, convenience store/minimart/gas stations, etc. For properties of this type there are three key ingredients:

Real Estate Value;
Business or Business Enterprise Value (BEV) sometimes referred as the Going Concern; and
Non-Real Estate Furniture, Fixtures & Equipment (FF&E).

"Non real estate" is specified because occasionally some fixtures, equipment and even furniture can be affixed to the real estate and legally become part of the real estate. The bulk value of 1, 2 and 3 is referred to as Total Assets of the Business. Total Assets of the Business was and is also known as the total going concern.

When a client calls for an appraisal of such a property it's critical to differentiate to the client whether it's for the real estate or Total Assets of the Business. Obviously, the real estate value will usually be the most direct and least time consuming part of the valuation. The appraiser can rely on a normal fee simple or leased fee interest real estate valuation depending on whether the property is leased or owner occupied. However, in many cases the client needs an appraisal of the "whole ball of wax" which means the Total Assets of the Business; sometimes referred as Total Going Concern. Obviously, the difference between the real estate value and Total Assets of the Business can be substantial. One exception would be a project which is near the end of its economic life and/or is heavily distressed. In these cases typically the real estate value is the overwhelming part of the Total Assets of the Business with the Business Enterprise Value, and Furniture, Fixtures & Equipment having minimal value. The Fixtures & Equipment would typically only have salvage value. However, in most cases, there is significant value to the real estate, Business Enterprise Value and Fixtures & Equipment. So step one is to communicate clearly with the client on whether real estate value or Total Assets of the Business, is being appraised.

Many properties of this type are set up into two entities:

Real estate holding company and
Operating business.

The real estate holding company then leases to the business operation; the real estate. The ownership of each can be arms length leases or a non-arms length lease between related parties. Regardless, the appraiser must review the historical financial statements including but not limited to leases, income/expenses and balance sheet for both entities. Only then can the appraiser understand the full composition of income/expenses and assets. In some cases there is only one entity. In the vast majority of cases, the remaining economic life of the real estate is much greater than the Business Enterprise Value or the Fixtures & Equipment. Thus, the overall capitalization rates for the allocation of Net Operating Income (NOI) to Business Enterprise Value and Fixtures & Equipment is substantially higher than that of the real estate. In a perfect world, the Sales Comparison Approach can be the strongest approach to value of Total Assets of the Business. The problem is verifying the allocation between real estate, Business Enterprise Value and Fixtures & Equipment. Since in New York State when recording a deed transfer, only the real estate sales price is reported and generally not the Business Enterprise Value and Fixtures & Equipment. Property taxes in New York State are based only on the real estate value. Sometimes buyers inadvertently include all three components when recording the deed. Form 5217 section 15H can be a source which clarifies whether the business is included in the sale. However, the amount of the business value is typically not disclosed on that form. Thus, the Sales Approach may be an inferior approach to that of the real estate.

Even if the amount of the Business Enterprise Value and Fixtures & Equipment are disclosed, many times the allocations may be too high for two reasons:

The less that is allocated to the real estate, the less the assessment and real estate taxes may be; and
Business Enterprise Value and Fixtures & Equipment can be depreciated for accounting purposes at a very rapid rate.

Thus, many times the real estate is under allocated. Another word of caution is in some cases if the Business Enterprise Value is near “0” a Fixtures & Equipment appraiser should be consulted to estimate the salvage value. The real estate appraiser’s strength is estimating Total Assets of the Business as one economic unit and allocating to the real estate value; not necessarily valuing independently Fixtures & Equipment and Business Enterprise Value; but creating an harmonious balance between the three in relationship to the Total Assets of the Business. In summary, Total Assets of the Business is becoming more of a trend in the appraisal market place.

John Rynne, MAI, SRA, is the president and owner of Rynne, Murphy & Associates, Inc., Rochester, N.Y.