How Commercial Real Estate Appraisals Affect Business Valuations

Commercial real estate appraisals are used regularly when the client's intended use includes more than one user, such as transactions, disputes, and estate planning. The real estate appraiser (appraiser) and business valuation analyst (analyst) are affected by the purpose of the engagement and standard of value through the approaches and the applicability of discounts used. This article analyzes the interplay between real property appraisals and the valuation of operating businesses. Factors affecting each of the three approaches to value are discussed and illustrated through examples.

GENERAL STANDARDS FOR COMMERCIAL REAL ESTATE APPRAISALS

For situations involving the courts or financial lenders, commercial property appraisals must comply with professional standards. The most common professional standards for real estate appraisals is the Uniform Standards of Professional Appraisal Practices, or (USPAP.) USPAP regulates the quality control for real property and other assets such as personal property, intangibles, and businesses. In Massachusetts, USPAP real estate standards are required for all divorce and estate planning engagements.[1] The appraisal report is an opinion of value based on three approaches to value: the cost, sales, and income approaches.

Sometimes an alternative to a USPAP-compliant appraisal is acceptable. Depending on the purpose, timing, and agreement between the parties, a broker's opinion of value[2] (BOV) may be utilized. The BOV reports are lesser in scope than a USPAP appraisal and often lack disclosures needed by the business valuation analyst. For this reason, this article will focus on only on USPAP-compliant reports.

COMMERCIAL PROPERTY

Among other disclosures, a USPAP-compliant report discusses the assumptions used in the cash flows generated by the property, including the rental income and expected expenses as well as the vacancy rate and any deferred maintenance. The income statement shown in **Figure 1** illustrates a sample income statement based on the property's expected net income. This may differ from the amounts reported on the tax returns and has been condensed for purposes of the example.[3]

The premise of the appraisal is that the property will continue to operate into the future rather than liquidate. Once the expected net income (or "benefits") has been determined, the cash flow adjustments and risks are analyzed to estimate the value using the income approach. The income approach concept for real property appraisals and business valuations will be discussed further.

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Real estate appraisals using USPAP result in a "market value" opinion. Market value is a type of value, stated as an opinion, that presumes the transfer of a property (i.e., a right of ownership or a bundle of such rights), as of a certain date, under specific conditions set forth in the definition of the term identified by the appraiser as applicable in an appraisal. When both the real estate appraisal and business valuation report follow USPAP, the standard of value is assumed to be consistent. This is not assured when the valuation analyst follows the standards of a different professional organization. For this reason, analysts should carefully read the definitions in the appraisal report.

The important takeaways for the business valuation is the determination of market rent and which expenses are paid by the landlord or tenant. While the lease may outline the

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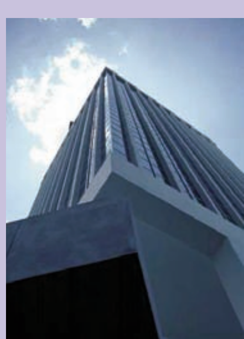
FIGURE 1



Rental Income	$100,000
Property Management	10,000
Insurance	15,000
Real Estate Taxes	6,000
Repairs and Maintenance	10,000
Replacement Reserves and Other	30,000
Total Expenses	71,000
Net Income	$ 29,000

expert **TIP**

The commercial property appraisal and the business valuation are linked, requiring careful analysis to ensure consistency in application between the two reports.

expenses paid by each entity, these may not reflect the actual payments or market rates. Absent a USPAP appraisal, the valuation analyst is generally limited to assuming the lease terms approximate fair market value.

There may be other financial forensic issues to consider when related parties are involved, due to the ability to control the timing and amounts of cash flows. In these situations, the financial information from both entities should be analyzed to understand which entity is reporting the costs, loans, or activities. Also, interviewing the owner(s), obtaining the detailed general ledger, or analyzing the source documents may be required to determine how the payments were treated by the parties.

THE OPERATING BUSINESS

The historical income statement from the operating business tax returns is presented in **Figure 2** below. For simplicity, only one year of operations is shown. Also, the accounts affected by the real estate are shown separately from all other operating expenses.

Note that the real estate appraisal figures from the previous section are based on the expected property income whereas the company's tax returns are based on historical financial information. The real estate affects the operating business through expenses such as rent paid, real estate taxes, property insurance, and repairs and maintenance. If the business owns the property, additional expenses may be incurred, such as depreciation and interest expense.

When the business pays the costs of the repairs and maintenance, insurance on the building, and property taxes, the lease is referred to as "triple net" or "NNN." **Figure 3** below illustrates the NNN expenses from the tax returns.

In our example, both the commercial property and operating entity are reporting the NNN expenses. In addition, the rent expense conflicts with the rental income used in the appraisal. These items will need to be analyzed for their effects on the business value and will be discussed further.

VALUING THE OPERATING BUSINESS

Similar to the USPAP appraisal, there are three approaches to value the operating business: asset, market, and income. The assumption is that the business will continue to operate into the future rather than liquidate. This is referred to as a going-concern premise. The following sections describe each approach and analyze how the real estate affects the business valuation.

ASSET APPROACH

The asset approach is a general way of determining the value indication by subtracting the liabilities from the assets of the business. When the property ownership is separate from the operating entity, any assets or liabilities associated with the land or building are typically removed from the business value calculations. For example, leasehold improvements would be unrecoverable if the business relocated and any improvements in the property value would be reflected in the real estate appraisal. On the liabilities side, any accounts payable, accrued liability, or notes payable need to be reviewed for items relating to the land or building.

When the business owns the property, the treatment depends on the function the real estate has in the business. If the property is an integral part of the process or service offerings, it would be considered operating for business valuation purposes. For example, a funeral home or hotel will typically sell with the land and building whereas a liquor store in a strip mall doesn't need a cabin in Maine to operate. The valuation analyst must determine whether the property is "operating" or "non-operating" in nature. If operating, the commercial property and related assets or liabilities would be included in the determination of the business value. If non-operating, the property would be segregated from the business and considered separately from all three approaches to value. Regardless of the determination, the business valuation report should specifically reference the source of the real property value.

MARKET APPROACH

The market approach to business valuation uses multiples from comparable business transactions or guideline public companies to value the subject company. The property appraisal affects the business value through the classification of operating or non-operating as described above and through the multiples used in the databases applied by the valuation analyst. One way to help assess whether the property is operating or non-operating is to review the

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FIGURE 2

Revenue	$ 1,000,000
Rent Expense	50,000
Insurance - Property	15,000
Real Estate Taxes	6,000
Repairs and Maintenance	10,000
Other Operating Expenses	719,000
Total Expenses	800,000
Pre-Tax Net Income	$ 200,000

FIGURE 3

Insurance - Property	15,000
Real Estate Taxes	6,000
Repairs and Maintenance	10,000
Subtotal	31,000

market approach in the real estate appraisal. If the comparable properties include the business, the property is likely to be considered operating for purposes of the operating entity value and vice versa.

The market transaction databases contain asset sales, stock sales, or both. For example, in the Pratt's Stats database, the fixed assets and leasehold improvements (if any) are assumed to transfer in asset sales whereas real estate rarely does. While the value will not be included in the transaction sales price, there will be disclosures in the "Additional Notes" section to assist the valuation analyst in applying the data. In stock sales, the entire legal entity is assumed to transfer and includes all assets and liabilities unless otherwise specified in the purchase agreement. Improperly including or excluding the real estate in the market approach could substantially overstate or understate the value calculation.

INCOME APPROACH

The income approach to valuing a business involves converting the subject company's future benefits into a present value. This process involves normalizing adjustments to the historical financial activity for such items as excessive (or lack of) officer's compensation, and items that are non-recurring or discretionary in nature. This article focuses on real estate considerations.

Similar to the real estate appraisal, the cash flow and risks are analyzed to estimate the value for the income approach. The analyst uses future economic benefits that are likely to continue and which are known/foreseeable at the valuation date. Determining which expense categories to adjust depends on how they are handled in the real estate appraisal.

Adjusting the Operating Business Financial Statements

Let's consider the duplicate "triple net" expenses and the difference in the rental income/expense between the property and business issues identified above.

First, if the commercial real estate lists the NNN expenses paid by the landlord, the duplicate payments in the business will understate the value. This is illustrated in **Figure 4** below. For simplicity, the tax effects and cost of capital determination are not discussed.

Second, the real estate appraisal describes the market rent the business should be paying to the real estate entity. If the business valuation does not adjust for the market rent, the business value would be overstated. This is illustrated in **Figure 5** below.

While the adjustments in the above examples have an offsetting effect, the net effect on business value would still be overstated $ 95,000 lacking the two adjustments ($250,000-$155,000). Careful review of the assumptions used by the real estate appraisers and lease agreements is necessary to ensure parity between the two reports and avoid unnecessary cross examination.

APPLICABILITY OF DISCOUNTS

There may be discounts to the value with respect to the underlying asset in the real estate appraisal for marketability ("exposure" or "absorption" time). Marketing time differs from exposure time, which is always presumed to precede the effective date of an appraisal. The application of discounts when valuing the business may create the potential for double dipping if the discount is already considered in the commercial property appraisal. It is important to note that the discount at the real estate level is separate from the discount at the business entity level.

At the property level, the calculation of any discounts may be determined by the real estate appraiser rather than the valuation analyst if the business owns a fractional interest in a parcel of real estate. Normally the appraiser allows for a reasonable exposure time to market and sell the property though may not indicate a separate adjustment in the appraisal report.

At the entity level, the valuation analyst may apply discounts for lack of control and lack of marketability to a minority ownership interest depending on the ownership interest being valued and the purpose of the engagement. For example, a fair market value engagement for gifting purposes may apply discounts whereas a fair value engagement for a Massachusetts divorce or other shareholder dispute purposes would not. A detailed discussion of the valuation discounts are beyond the scope of this article.

SUMMARY/ CONCLUSION

The commercial property appraisal and the business valuation are linked, requiring careful analysis to ensure consistency in application between the two reports. Careful reading of the real estate appraisal is required to ensure the assumptions are consistent between the property appraiser and business valuation analyst. Understanding the professional standards followed by both appraiser and valuation analyst are key to obtaining reliable opinions. The purpose of the engagement and standard of value used may substantially impact the assumptions used and opinions generated. Ignoring the nuances can affect the business value through normalizing adjustments and discounts applied.

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FIGURE 4

Duplicate NNN Expenses	$ 31,000
Sample Capitalization Rate	20%
Potential Effect on Value, Rounded	$ 155,000

FIGURE 5

Market Rental Difference	$ 50,000
Sample Capitalization Rate	20%
Potential Effect on Value, Rounded	$ 250,000

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[1] Commonwealth of Massachusetts, Board of Registration of Real Estate Appraisers, Office of Consumer Affairs & Business Regulation (OCABR), Division of Professional Licensure, http://www.mass.gov/ocabr/licensee/dpl-boards/ra/, last accessed August 15, 2016. The Board adopted the standards established by the Uniform Standards of Professional Appraisal Practice. Note: The Board does not have reciprocal agreements with specific states.

[2] A Broker Opinion of Value is an educated "best guess" as to a commercial property's current market value based upon a careful assessment of market and property conditions that affect the value of a commercial property, CBRE http://www.cbre.us/o/fortlauderdale/teams/south-florida-multi-housing-private-capital-group/Pages/broker-opinion-of-value-bov.aspx, last accessed August 15, 2016.

[3] For simplicity, the rental income is assumed to be net of the vacancy and credit loss considerations.

[4] "Definitions," USPAP (The Appraisal Foundation, 2016-2017).

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