

# Going Concern Valuation

PropSci University

Presented to select clients

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# Goals of Presentation

- Review definitions and how we can apply them
- Identify possible sources and examples of value components
- Discuss methods to quantify going concern value components
- Provide Property Sciences' interpretation of latest SBA's SOP

# Definitions

## Business Enterprise Value (BEV) (what we refer to as Business Value)

“**total intangible assets**...such as marketing and management skill, assembled workforce, working capital, trade names, franchises, trademarks, contracts, leases, customer base and operating agreements.” *(p. 25, Dictionary of Real Estate Appraisal, 5<sup>th</sup> Edition, 2010)*

## Going-concern value

“Market value of all tangible and intangible assets of an established and **operating business**....” *(p. 88, Dictionary of Real Estate Appraisal, 5<sup>th</sup> Edition, 2010)*

## Other definitions of going concern

Include references to “operation production mechanism” or “operating business.”

# Applicability to Real Estate Valuation

## Purpose of Appraisal

Estimate 'as-is' market value of real estate (or going concern)

## Implicit in value definition is highest and best use

“the **probable use** of land or improved property – specific with respect to the **user** and timing of the **use** - that is adequately supported and results in the highest present value.”

**USPAP requires appraisal to consider Intangible & FF&E value contributions.**

# Difference between Business & Real Estate Value Models

EBITDA

NOI  
(after FF&E)

TIMES MULTIPLE

DIVIDED BY CAP  
RATE

VALUE OF  
BUSINESS

VALUE OF REAL  
ESTATE

Adapted from *Appraisal Journal*, "Restaurant Valuation, Spring 2014"

# Difficulty in Definitions

BUSINESS  
VALUE  
(INTANGIBLES)



VALUE OF  
BUSINESS

# Definition Disconnect

“USE OF REAL ESTATE”  
(FROM HIGHEST AND BEST USE)

AND

“OPERATING BUSINESS”  
(FROM PUBLISHED DEFINITIONS)

# What Do Regulators Say?

## Comptroller of Currency

### - Three components of going-concern value

- Market value of real estate
- Personal Property Value
- Value of intangibles

• (p. 103, *Commercial Real Estate Lending Guidelines*, Comptroller of Currency, August 2013)

## SBA SOP

– “If the ...engagement...asks for a business enterprise or going concern value, the appraiser must allocate separate values to the individual component...including land, building equipment and business (including intangible assets).”

• p. 172, *SBA SOP, 50 10 5(F)*, January 2014)



# How Do We Reconcile?

FOCUS ON COMMON WORD

## **INTANGIBLE VALUE (BEV)**

(both real estate and operating businesses can have intangible value)

# Possible Factors of Intangible Value

- **NAME OR TRADE NAME**
  - Celebrity chef naming rights
  - Property part independent hospitality chain
  - Nationally known healthcare operator
- **CUSTOMER CONTRACTS**
  - Analogous to positive leasehold interest
- **CUSTOMER BASE**
- **ASSEMBLED AND SKILLED WOKFORCE**
  - Understanding of government reimbursement procedures
- **SPECIAL LICENESES OR PERMITS OUTSIDE OF LAND USE LAW AND IS TRANSFERABLE**

# Situations when Intangible Value could exist

- Property has independent brand recognition.
- Property is performing at an above market level after adjustment for all real estate attributes (ie location, improvements, amenities, services provided).
- Higher likelihood of intangible value exists as complexity or uniqueness of property increases.

# Case Study of Possible Intangible Value

## New Project - Wine Country Inn

- Partner with young upcoming winemaker.
- Named Jacqueline Inn.
- Jacqueline's wines are great, she is successful, starts her own nationally recognized vineyard and has brand recognition.
- Buyer comes in with offer to continue to operate Inn under her name.
- Could there be an intangible value?

# How do we recognize these Value Generators?

## WHAT DO APPRAISERS DO?

- **GO TO THE MARKET TO OBSERVE WHAT PARTICIPANTS ARE DOING!**

- Rarely is there a relationship between contract price allocation and value contributors.
- How do buyers think?
  - Never want to pay more for real estate than they can.
  - Often assume they can operate property better-create value, prefer properties under-performing.
- Buyers pricing decisions (OAR or IRR) includes a return on and return of capital
- How do sellers think?
  - Never want to give anything away for nothing – would require compensation for any intangibles.
  - Market readily recognizes value of brand recognition.

# Is there typically INTANGIBLE VALUE in sale of franchised hotel?

## NO

- Franchise rights are not transferred but are a separate agreement with buyer and franchisors. Neither seller nor buyer owns franchise rights.
- Hotels are often franchised under different affiliations upon resale.
- Owner pays fees to franchisors for value of franchise affiliation. These fees are much greater than just affiliation and marketing fees.

# Is Management an Intangible?

You are evaluating a bed and breakfast in which the owner lives on-site and manages the property. He does not deduct management expense or pay himself a salary. He values the going-concern taking NOI from P&L by using a cap rate. **Would there be intangible value for his management involvement?**

**NO**

- Instead, an estimate of his management time could be deducted to calculate a market NOI.
- The involvement of an owner in a going-concern rarely creates intangible value
- *Unless your name is Trump.*

# Then why do franchised hotels sell for more per room than non-franchised hotels?

Because the real estate and FF&E are worth more

- Franchised properties have to meet rigorous physical plant and FF&E standards.
- Experienced hotel operators can create value by buying, remodeling and re-branding hotels.
- No different than re-configuring retail or office buildings.



# What necessary appraisal procedure first needs to be applied to Going Concern property valuations?

## ANALYZE EXPENSES!

- As with any assignment
- And required by USPAP
- The appraiser **MUST** properly analyze expenses by categorizing them consistent with industry standards and
- Compare them to statements of comparable properties and industry standards.

# Example of Senior Care Property

You are valuing one senior care facility  
and the owner-operator has a total of six facilities.

- You note that this property has expenses 10% lower than other similar properties.
- Could these lower expenses could contribute to intangible value?
- Correct treatment would be to mark those expenses to market.

# Estimate of Value of Intangibles

## Residual Analysis

- Going-Concern Value (from Income and Sales Comparison Approaches) subtracted from Real Estate and FF&E Value (Cost Approach)
- Only Technique Which Starts with Value of Real Estate and FF&E

## Other Techniques

- Income Analysis - When Impact of Intangibles on Income is quantifiable
- Parsing Income – example of hotel spa
- Cost Analysis - Estimate of Costs to Create Items Having Intangible Value

# Intangible Value by Residual Method

## Value of Going – Concern

- Income and DSC Approach - \$1,500,000
- Value of Real Estate & FF&E -\$1,200,000
- Indicated Value of Intangibles - \$300,000

## Advantages

- Easy to Understand
- Starts with Underlying Real Estate Value

## Disadvantages

- Subjective Depreciation Value (especially FF&E)
- Is value of entitlements in zoning or permits?

# Income Analysis – Incremental Income

## Value of Intangibles of Jacqueline Inn (JI)

	Market	JI
RevPar	\$168	\$174
Difference in RevPAR	\$6	
Rooms	38	
Difference per Night	\$228	
Difference in Annual Income	\$83,220	
Percentage Contribution to NOI	90%	
Difference in NOI due to Intangibles	\$74,898	

# Income Analysis Capitalization

Difference in NOI due to Intangibles	\$74,898
Cap Rate	9%
Estimated Discount Rate	11%
PV of Payment, 5 years, 11%	\$276,815
Incremental Value per Room	\$7,285

# Cost Analysis

## Construct Cost Analysis to create Intangible

- Licensing for Senior Care
- Cost to assemble skilled workforce
- Cost to stabilization

# Reconciliation

After Going-concern and Intangible Values have been arrived at, is there a logical explanation on what intangible value represents?

## Examples

- Value created from association with now famous wine-maker
- Licenses to operate senior care
  - Branding or association with nationally known operator
- Value of retail operation and synergy with fuel sales



# Current SBA Requirements | General Case

*“When the collateral is a special purpose property, the appraiser must be experienced in the particular industry”*

*SBA SOP 50 10 5 F, SOP, Chapter 4, Section II,(C)(1),(i), page 172*

- Our interpretation is that the guidelines state only that a special purpose property needs to be appraised by an appraiser with “experienced in that particular industry” but does not mention any special designation. We could not identify any definition of what this experience could consist of.

# “Experienced in Industry” Tests

## Experience

- Number of specialty property appraisals completed annually?
- Has individual in firm worked in industry?

## Data

- Comparable expense comparable data base?
- Industry publications

## Reputation

- Attend industry events?
- Known by brokerage and investor communities.

# Current SBA Requirements

## High Loan Exposure to Intangibles

*“If the amount being financed...minus the appraised value of real estate and/or equipment is greater than \$250,000...the lender must obtain an independent business valuation from a qualified source.”*

*SBA SOP 50 10 5 F, Chapter 4, Section II,(C)(5),(a thru g), page 174 -175*

- Our interpretation is that if transaction involves a “Business Valuation’ [which could include real estate] and a change of ownership, and if the Lender has a **loan exposure of over \$250,000** of business value, only then must the appraiser doing the business valuation must have a relevant professional designation (as defined as follows). Relevant Designations – ASA, CBA, ABV, CVA, AVA

# Recommendations for loan exposure to intangibles

**Order appraisal of business  
and  
appraisal of real estate**

# Recap

- Requirements of Comptroller and SBA focus on reflecting “intangible value”.
- Definition of Going-Concern is still unclear relating to real estate but includes tangible (real estate and FF&E) and intangible values.
- Intangible value can include value of name, customer base and contracts, and skilled workforce.
- Incumbent upon appraiser to properly analyze and project operating expenses, consistent with industry standards.

# Recap (continued)

- Nationally franchised hotels generally do not contain any intangible value as rights to name are owned by franchisor, who is compensated for those rights.
- There are several methods of estimating intangible value, however, the most common approach is to subtract the real estate & FF&E value from the going-concern value.
- The estimated intangible value should be tested for reasonableness.
- For most special purpose properties the SBA requires a “qualified individual”.
- Institutions should have quantitative standards for “qualified individuals”.

## Contact Info

**Arthur O. Neudek, MAI** | Vice President

The Property Sciences Group, Inc.

Phone 925-246-7342

Email [Arthur.Neudek@PropSci.com](mailto:Arthur.Neudek@PropSci.com)

**Herb Jourdan, MAI, SRA** | Chief Appraiser

The Property Sciences Group, Inc.

Phone 407-474-1293

Email [Herb.Jourdan@PropSci.com](mailto:Herb.Jourdan@PropSci.com)

