Separating The Real Property From The Tangible And Intangible Personalty In Appraisals

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Allocating the various assets of a going concern in order to isolate the real estate value requires an understanding of the principles involved and careful application of the appropriate approaches to value.

USUALLY, ESTIMATING THE VALUE of real property is fairly straightforward. The appraiser capitalizes the rent for the real property, estimates a depreciated cost of the improvements and adds the site value, or makes a direct comparison to sales of similar real property. These are the three traditional approaches to value identified in nearly every real property appraisal text or course. Sometimes, however, the appraiser is not able to get directly to the real property rent or sales price. In these situations the valuation of just the real property can get messy. Hotels, regional malls, night clubs, health care facilities — to name just a few — are property types that illustrate the problem. The real property component of these properties is often tightly bundled with other assets, such as tangible and intangible personal property and monetary assets.

Developers don't build hotels or nursing homes, as a rule, then put the buildings up for rent or sale. Instead, the revenue and sales price represent the total assets of the business. When these property types are the subject of a valuation of just their real property component — in real property tax assessment or condemnation, for example — then the appraiser is forced to begin with the revenue or sales price of the total assets and remove from it that portion attributable to the non real property components. "If only tangible assets are subject to property taxation, then the value of monetary and intangible assets must be extracted as a first step."[1] The need to conduct an allocation is not subject to debate. How the allocation is accomplished, however, can be controversial. This article will examine the strengths and weaknesses of the various methods advanced for making the allocations.

BASIC PRINCIPLES • There are several economic principles and concepts that underpin allocation of the total assets of a business. Again citing Smith and Parr, "In spite of the fact that the ground is occasionally swampy, the structure around which we value intangible assets and intellectual property is not without firm foundation. That rock is one of the immutable laws of business — return on investment."[2] It is this concept that underpins any allocation method. It also helps explain why some of the more popular methods are flawed as applied. Other key principles and concepts include opportunity cost and economic profit. The former is defined as, "the payment needed to attract productive resources from the next most rewarding alternative use."[3] It illustrates why the value of an asset such as a franchise, requires recognizing both a return "of" and "on" the asset. It explains why the widely held idea that the value is represented by how much one pays to obtain the franchise is incorrect: Because it fails to capture the anticipated return "on" that asset.

Economic profit is the residual, if any, after all agents of production (land, labor and capital) have been paid at their opportunity cost. It is a flow to the entrepreneur and by definition is an intangible. Business valuers refer to this profit as "excess earnings" or goodwill. To the extent it exists in a going concern, when the value of just the real property is sought, the economic profit must be removed from both income and value. We will see both of these economic concepts illustrated in the discussion of valuation methods that follows. Before exploring the methods for removing the tangible and intangible personalty, however, we must first identify what they comprise.

Examples Of Businesses That May Require Identification, Separation, And Measurement Of Intangible Assets

For a hotel, tangible personal property might include the following: room furnishings, kitchen and dining equipment, laundry equipment, maintenance equipment, recreation equipment, signs, beverage service and lounge equipment, audiovisual equipment, computers and office equipment, linens, vehicles, inventory and security system. The intangible personal property might include a franchise, assembled workforce, business name, non realty contracts, non realty leases, business organization and innovations. One of the better sources for a breakdown of many of these assets, and their respective costs, is a franchise offering circular, which is available from most hotel companies that franchise.

For senior housing the tangible personalty might include room furnishings, kitchen and dining equipment, medical and surgical equipment, laundry equipment, maintenance equipment, recreation equipment, signs, lounge furnishings, audiovisual equipment, computers and office equipment,

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[1] Gordon V. Smith and Russell L. Parr, Valuation of Intellectual Property and Intangible Assets, 3rd Ed. (John Wiley & Sons, 2000), 443 (hereinafter "Smith and Parr").

[2] *Id.,* at x.

[3] Appraisal Institute, Fundamentals of Separating Real Property, Personal Property, and Intangible Business Assets. (Chicago: Appraisal Institute, 2011). 2-21.

linens, vehicles, inventory and security systems. The intangibles might comprise an assembled workforce, licenses, physician and specialist relationships, business name, non-realty contracts, non-realty leases, business organization, innovations.

Shopping center tangible personal property might include furniture, office equipment, security equipment, strollers, vending machines, inventory and carts. The intangibles might include the business name, non-realty contracts and leases, increased in-line retail tenant sales attributable to the image of anchor tenants over and above any concessions made to entice anchor tenants to locate in the center, and innovations (retail markup of services or utilities bought at wholesale, unique space layout or tenant location synergy, valet service).[4]

Many other properties are candidates for allocation, including restaurants, apartments, office buildings and manufacturing firms. Suffice it to say, if indications exist to suggest the possible existence of non-realty assets, the appraiser must undertake the investigation necessary to identify them and remove them from the income and value.

Indications Of The Possible Existence Of Intangibles[5]

Valuable intangible assets may exist if an appraiser detects any of the following:

- The real property cannot be valued directly. This is the most obvious signal that more than real property exists. Examples include hotels and regional malls, which rarely sell or rent as just pure real estate. How often, for example, have you driven by an empty hotel with a "for rent" or "for sale" sign in the yard? These properties are not built speculatively, then put up for rent or sale. As a consequence, the appraiser must begin an income analysis by starting with the revenue to the total assets of the business. From this, income attributable to the tangible and intangible personal property is removed. Compare this to a conventional warehouse. Here the appraiser is not concerned with the business revenue, as the rent for the real estate can be ascertained directly. The same is true of comparable sales. The appraiser must remove from the comparable sale price the contribution of all tangible and intangible personalty before comparing the residual real property price to the subject;
- Net income is based primarily or exclusively on percentage rentals. Shopping centers are often leased this way. Instead of establishing a discrete rental for the space the amount charged for occupancy is determined to be a percentage of the sales occurring in the space. The higher the sales, the higher the "rent";
- Change of flag (hotel, restaurant, health care-health care, mall, etc.) consistently and perceptibly increases revenues. Consider a hotel flagged and operated as a Hilton. The owner switches to Marriott and the income perceptibly increases yet nothing has changed with the real estate.

Valuation

All three of the traditional approaches to value potentially apply in situations where the going concern comprises several bundled assets but only the value of the real property is sought. Each has its strengths and weaknesses.

Cost Approach

This is the most straightforward approach, as it completely eliminates the need to address the tangible and intangible personalty. This is its primary strength. Among the drawbacks, however, care must be taken to distinguish between market value and value in use. For example, if the real property currently housing a McDonald's restaurant is the subject of the analysis, care must be taken not to

[4] *Id.,* at 6-107-110.

[5] *Id.,* at 8-138.

include those elements of the property that are of value to McDonalds but to no one else. Also, some jurisdictions may prohibit it — or limit its use — by law, and some courts have been highly critical of it as a realistic approach.[6] Another weakness is the fact that few investors in investment realty — as opposed to amenity realty, such as a residence — rely on cost as a true measure of value. Key to successful application, of course, is a reliable measure of accrued depreciation. Of the generally recognized methods for developing depreciation — age/life, market extraction, break down and feasibility rent — the first is usually not reliable if the cost approach is to be given considerable weight in the valuation. It is usually too simplistic to reliably capture all elements of depreciation. The others can be difficult applications but if done properly will result in reliable conclusions.

Sales Comparison

Sales of businesses with a significant real property component occur, often frequently. For example, sales of hotels are usually abundant. However, what sells is the total assets of the business rather than just the real estate. Furthermore, although some deeds show an allocation of the various assets, rarely is it based on acceptable market value methodology. These allocations, therefore, have little application to a true valuation problem. Sometimes the allocation is done for income tax reasons or the like, and the methodology is tailored to achieving a favorable outcome for that purpose rather than representing a pure split on market value lines. So, if sales comparison is to be used the appraiser must have a way to reliably remove the contributions to the price of the tangible and intangible assets. Not an easy task. Alternatively, the sales might serve the very limited purpose of illustrating how much the subject real property cannot possibly be worth. In other words, if the total assets of a regional mall sell for $50,000,000 all else equal it tells us that the mall real estate cannot possibly be worth that much. Sometimes it tells us little else.

Income Capitalization

This is the most frequently used method to value the real property component of a going concern. It has similar issues as the sales comparison approach but is more manageable because the appraiser usually has access to much more detailed information on the subject's income than he/she does for the comparable sales.

Several methods have been advanced for application of income capitalization. All require the appraiser start with the income to the total assets then remove income attributable to the tangible and intangible personalty. Key here is not to lose sight of those fundamental principles addressed at the beginning of this paper: return "of" and "on" the asset, opportunity cost, and economic profit.

Removing The Tangible Personal Property

This requires removing both the return "of" and return "on" the tangible personalty. It begins with an estimate of its value. Once this is estimated a return "on" and "of" it can be calculated using the same method you might use to quantify the annual debt service for a loan. After all, debt service (which is simply the loan value multiplied by the

[6] To say that the cost approach is generally disliked by the courts is an understatement. Another court has stated: "A third method of appraisal is somewhat tentatively and timidly put forward by the claimant, the reproduction method. Here an expert is called upon to give his version of the sound value of the building by estimating what it would cost to reproduce it, and then deducting a fair amount for depreciation. This 'method' is perhaps the most excellent example conceivable to demonstrate that none of such abstractions ought to have a place in the search for market value, generally speaking…[I]gnoring the fact that on the figures an absurd result is reached, it is apparent that the reproduction method is in itself absurd in the ordinary case, because even in ordinary times, it is ridiculous to suppose that anyone would think of reproducing this or any like property, and that same thing would be true in the vast majority of cases, I should think." (*United States v. 49.375 square feet of land in Borough of Manhattan*, 92 F. Supp. 384, 387-388 (S.D.N.Y 1950), from Real Estate Valuation in Litigation, 2nd ed. (Chicago: Appraisal Institute, 1995) p.158.

mortgage constant, which is the loan capitalization rate) results in the lender receiving back what he/she lent, plus a return on it equal to the annual interest rate charged. As an example, assume the purpose is the valuation of the real property component of a 136 key select service hotel. The cost new of the furniture, fixtures and equipment (FF&E) is $25,000 per key. It is 50% depreciated and so its value is estimated to be $12,500 per key. Identifying a capitalization rate of 11.5% as appropriate for the tangible personalty, the annual deduction necessary to remove it from income is calculated to be $1,436 per key (Income = Value x Rate, so $12,500 x .115 = $1,436).

The biggest controversy/misunderstanding associated with this model is confusing a replacement allowance, which is simply an operating expense, with removal of the asset. Both deductions are necessary. This is simple to understand by considering what would have to be done if the total assets were being valued instead of just the real property. In such a case a deduction for a replacement allowance would be necessary, often calculated as either a percentage of total revenue or $/unit. So, if valuing the real property alone, the same deductions that would be made if valuing the total assets would be necessary, *plus* deductions for removal of the tangible personalty. The difficulty some have with grasping this simple concept is illustrated by the several court cases that have ruled it to be double counting, although as many others have been able to appreciate the concept.[7] One way to see it clearly is to consider the valuation of a conventional apartment community. In a direct capitalization model a deduction is almost always made for a replacement allowance to cover such real property components as the roof and parking lot. By making these deductions, however, no one believes the result is income attributable to an apartment community without roofs or parking lots. If the assignment were to value the community without those features, then another deduction would obviously be necessary. Same is true for furniture, fixtures and equipment.

Removing The Intangibles

Deductions from the income stream would be necessary to account for a return "on" and "of" each of the intangible assets contained in the going concern. Some have suggested it is not appropriate to have the real estate as the residual, and that only the intangibles can be residual. Business valuers disagree. Again, citing Smith and Parr, "If only tangible assets are subject to property taxation, then the value of the monetary and intangible assets must be extracted as a first step."[8]

First, the appraiser needs to identify the various intangibles. Candidate assets were described earlier in this paper. For hotels, recall, franchise, assembled workforce, business name, and innovations were among those probable.

Let's consider just the franchise to illustrate a couple of methods advanced to accomplish the removal of intangibles, noting both strengths and weaknesses of each.

Franchise Fee Method (Rushmore Approach)

This method suggests that deduction of the cost of the franchise — the annual royalty rate—somehow accomplishes removing the value of the asset from the income stream. Related is the *relief from royalties method,* which contends the value of an intangible asset equals the present value of the royalty expense that is avoided (i.e., saved) through ownership of the asset.[9] The problem with it is it ignores the very reason one buys a franchise: the expectation of receiving back what has been paid for it plus an acceptable return on that amount. When an investor

[7] *Chesapeake Hotel LP v. Saddle Brook Township,* 22 N.J. Tax 525 (N.J. Tax 2005).

[8] Smith and Parr, supra, at 443.

[9] Appraisal Institute, supra, at 10-164.

enters into a franchise agreement with Marriott, for example, the investor does so with the expectation that the hotel revenue will increase as a result to a level that the investor will receive back from it what he/she is paying Marriott for the franchise *plus* an acceptable return on what is being paid. Recall the concept of opportunity cost. If an investor thought the value of a franchise was equal to what he was paying the franchisor and no more he would be concluding that he gets nothing from the franchise agreement. If that were the case, the concept of opportunity cost would indicate the investor would not enter into the agreement. Rather the investor would simply invest the cost of that franchise in an investment that would provide a return "on" the investment, regardless of how little. Anything would be better than receiving no return at all. As noted in the California State Board of Equalization, Assessors' Handbook, Section 502, *Advanced Appraisal,* "The value of intangible assets and rights cannot be removed by merely deducting the related expenses from the income stream to be capitalized. Allowing a deduction for the associated expense does not allow for a return on the capital expenditure." As explained in Smith and Parr, "The income approach is the primary method for valuing franchises and must reflect: Franchise Value = Present value of cash flows for franchised firm after payment of running royalties and a lump sum initial franchise fee *minus* Present value of cash flows for non-franchised firm."[10]

So, the strength of the franchise fee method is it is simple to use. The weakness is that it fails to capture the return "on" the asset.

Excess Earnings Method

This is an excellent tool and is used extensively by business valuers. They typically use it to identify income attributable to the intangibles as residual to removal of income to tangible real and personal property. It usually involves a calculation of income to the real property based on a cost approach for its value and then the relationship: Income = Value times Rate. The fundamental relationships used in the method are illustrated in the following formulas. V = I ÷ R (Value is equal to Income divided by Rate). Therefore,

I = V x R (Income is equal to Value times Rate).

VTAB = VRP + VTPP + VIPP + VFA (Value of total assets of the business is equal to Value of the real property plus Value of the tangible personal property plus Value of the intangible personal property plus Value of financial assets). Therefore,

VIPP = VTAB – VRP – VTPP – VFA

Inasmuch as the whole issue here is identification of the value of the real property, this method is hardly applicable in this form. However, the concept does apply. The formula can be rearranged to apply to real property:

VRP = VTAB – VIPP – VTPP – VFA

Furthermore, the same relationships work with income, so

ITAB = IRP + IIPP + ITPP + IFA

Therefore,

IRP = ITAB – IIPP – ITPP – IFA

This method is what real property appraisers refer to as the proxy rent method or the parsing of the income method.

This is a very workable and reliable technique, though it requires supporting a capitalization rate for each of the components. It too is based on the fundamental relationship: Income = Value times

[10] Smith and Parr, supra, at 327.

Rate. If the correct cap rate can be supported, then it will work as long as the appraiser can also support a value of the intangible component.

Using a hotel example, if the appraiser starts (as the appraiser necessarily must) with the income to the total assets of the business and then deducts expenses to the total assets, then deducts income representing a return "on" and "of" the tangible personal property, then deducts income representing a return "on" and "of" each of the intangible assets included in the total asset income, what is left over is the income to the real property, which can be divided by an overall capitalization rate to reveal value of the real property.

Strengths of this method are that it handles the fundamental concept of recognizing and removing both a return "on" and "of" each of the assets. The primary weakness of the technique is that it is not easy. Great care must be taken to ensure the appropriate contributions to income are used for the assets being removed. If they are too high, then the residual real estate value will be too low. If they are too low, then the residual real estate value will be too high.

CONCLUSION • Any of the three traditional methods of value is acceptable as long as it accomplishes removal of both a return "on" and "of" the value of the various non realty assets. Most appraisers recognize the income approach as the preferred method, however, and correct application requires identification of the various assets, then making the appropriate deductions to arrive at the residual income to the real estate. Citing Smith and Parr once more, "if only tangible assets are subject to property taxation, then the value of the monetary and intangible assets must be extracted as a first step." In effect, it is the excess earnings method except with real property instead of intangibles as the residual.