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Business enterprise value and new requirements

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Effective October 1, 2011, the Small Business Administration (SBA) updated its appraisal policies relative to business valuation requirements and going concern appraisals. According to the new requirements, real property appraisers who do not hold a business valuation designation must successfully complete a course on allocation for going concern appraisals when there is a change in ownership and the amount loaned on the business component is greater than $250,000. The Appraisal Institute course titled, Fundamentals of Separating Real Property, Personal Property, and Intangible Business Assets, is the only course recognized by the SBA for this particular type of appraisal assignment. It would therefore behoove all those appraisers that may be involved in such valuations to take this course and successfully pass it's exam.

Overall, the course is not intended, as some might expect, to set forth the procedures for the valuation of any particular going concern, such as a hotel, golf course or car wash as examples. It is primarily designed to assist the appraiser in identifying assignments that involve the valuation of a going concern and how to decipher what is tangible and intangible property. Some relatively new nomenclature was introduced in the course, including Market Value of the Total Assets of the Business (MVTAB), Capitalized Economic Profit (CEP), Capital Charges or Economic Rents (CAC) and Multiple Period Excess Earnings Method (MPEEM), to name a few. As there are multiple methods of valuation, the particular instructor indicated that neither the course nor the Appraisal Institute advocate any particular theory or method.

As I specialize in the valuation of hotels, I could not help but to view this course in context of this particular property type. Clearly, hotels have both tangible and intangible property. In addition to the main tangible assets, those being the building and site improvements, hotels also contain a significant amount of tangible assets in the form of furniture, fixtures and equipment (FF&E). In terms of intangible property, items that come to mind include all of the benefits that may accrue to the MVTAB from the hotel affiliation or flag; direct marketing and management. I'm sure no one would disagree that all of these tangible and intangible assets contribute to the MVTAB. How many room nights would you rent without a bed? Could you achieve maximum occupancy without marketing? For the chain affiliated hotel, how many room nights could be secured without the Internet, specialized reserve systems or even rewards programs? Obviously, all of these things contribute to the MVTAB. However, to me, the critical factor in estimating the market value of a going concern in a hotel is how to account for these components and consistently account for them within the three main valuation approaches. While the Cost Approach is ideally useful method for the valuation of a new facility, it has limited applicability for older hotels that are subject to a myriad of forms of obsolescence. Further, the approach does not consider the value of the intangible assets. The Sales Comparison Approach is also a useful tool. However, it is critical to thoroughly investigate each transaction as reported sales prices may or may not include the value of the FF&E. Further, the prices often reflect contracts in place for the franchise, which may come with significant and costly required property improvement plans (PIP). Due to the typical limitations of these two approaches, they are often given less weight in reconciling a final value estimate for the valuation of going concern, especially if they are profitable. The approach that is generally favored for the valuation of a hotel is the Income Capitalization Approach. It is my opinion that in most cases, this approach best recognizes all of the components of MVTAB.

The Income Capitalization Approach typically provides the most comprehensive tool to value a going concern through the inclusion of all revenue sources and all operating expenses of both the real estate and the business. While books have been written about what value accrues to the business versus the real estate, for the purpose of brevity I will only discuss some of the main issues. In terms of revenues, it is not practical in a typical valuation to parse the revenues by sources of real estate versus business - although, both components generate income almost without exception. However, a closer examination of the standard income statement would suggest that large shares of the revenues that are generated by the operation of the business are partially offset by the expenses associated only with the business. For example, many hotels are aligned through agreement with a hotel franchise that provides services to the hotel including management training, reservation systems, national presence and advertising and rewards programs. For many hotels, the revenues generated by these sources can be significant and oftentimes is well above what a hotel could generate without such an association. However, for these services, the hotel chain receives remuneration in the form of royalties and other fees. These fees can range widely, but typically range between 6% and 12% of total room revenue. Further, the chain also retains the ability to maintain the quality of the brand through strict adherence to quality controls. These requirements, in the form of continuous upgrades to the physical plant, are clearly expensive. As such, much of the value derived from the typical franchise agreement is offset by both ongoing operating expenses and frequent required capital expenses. Through the inclusion of franchise fees that compensate the franchisor for these services, much of the intangible value of this business component is extracted from the going concern. A similar argument can be made for management, which is reflected in both revenues and expenses. While clearly a case can be made for super management that generates above average revenues, it is often posed that such excess revenues are fleeting. Further, they are virtually impossible to prove given the wide number of factors that must be considered. Therefore, through the inclusion of these expenses in the Income Capitalization Approach, much of the intangible business value is extracted from the MVTAB. While a comparison of independent versus a chain-affiliated hotels might lead one to consider that the franchise fees are insufficient to extract all of the business value from this arrangement, it is typical for administrative and advertising expenses to be much higher for an independent hotel.

With regard to the value accrued from the FF&E, our firm uses a methodology that estimates the economic rent for this equipment, which is essentially a reasonable rate of return on the book value of the assets. Furthermore, we also consider the need for the replacement of these short lived capital items through the inclusion of a reserve for replacement in the cash flow. The discounted present value of the residual cash flows then provides a good indication of the value of the asset that will secure a loan. The method described is clearly a residual approach to the value of the real property rights. For hotels, this residual method is used almost exclusively in the market. However, for some going concerns there is data that can be used directly to estimate the market value of the tangible real property. In the case of golf courses, there are lease agreements for the real property, which if capitalized directly, would provide a good indication of the value of the real property only. Unfortunately, not many hotels are leased and therefore, due to the paucity of data, the approach is rarely, if ever used.

Overall, the parsing of the value of a going concern into tangible and intangible assets will likely be the subject of many debates in the future. What the Appraisal Institute's course on the subject matter astutely points out is that each property and valuation is unique and it's the analyst's job to decipher to what extent the business acumen of a particular management company or person contributes to the Market Value of the Total Assets of the Business.

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