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Real Estate Complications in Small Business Valuations

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Business appraisers/valuators know that the amount of effort required to value the small, closely held business is often underestimated by those outside the profession. Seldom is such a task performed without a certain amount of complication. In small closely held businesses, valuation complications are often increased because of the various ways in which real estate is used and owned. This article discusses several of the critical issues involved in the proper consideration of real estate when valuing the small closely held business.

A business can generally be held in one of several forms, including individually (a proprietorship), or through a partnership, corporation, limited liability company (LLC) or trust. The real property that a business uses can be held in the same form, although not necessarily in the same entity or by the same owners as the business.

Property Owned Apart from the Business

Real property might be held in an entity separate and apart from the business assets for several reasons, including:

- The real property is not entirely owned by the same individuals who own the business. There are common, but not identical owners, for both the business and the real property.
- The owners are using the real estate to draw additional "compensation" from the business in the form of higher rents rather than paying dividends or paying payroll taxes on additional wages.
- As part of an asset protection plan, the real property ownership is established apart from the business to protect assets from potential claims.
- The real property ownership is structured to preserve inherited or premarital property from becoming a marital asset.
- The real property ownership is established apart from the business because contractual provisions prohibit the entity from owning real property or make it more advantageous that the business not own property.
- Estate tax planning objectives dictate real property ownership separate from the business.

Problems

In situations where the real estate is owned separately from the business (not owned by the same entity that owns the business assets), the valuation concern is that the rent charged to the business might be other than fair market value (FMV) or the rent charged may be for more property than the business needs to use or is using in its operations.

Real Estate Owned by the Business

In situations where the real estate is owned with the business, there are several valuation issues:

- Is the real estate being put to its "highest and best use?"
- Are there "non-operating" elements of the real estate that would also include personal use portions?
- Does the long-term debt have a lower interest rate, longer term or exist solely because of the real estate as opposed to the borrowing capacity of the business itself?
- What is the difference in the capitalization rates and the attendant risks associated with real estate versus the other business assets?
- What is the comparability of the subject to peer group or market data where similar businesses generally do not own the real estate?

Problems

Best Use. When the real estate is not put to its highest and best use, the income returns from it are not as great as they could be. Where the property is owned by the business, the overall returns to the business could be increased by moving to more appropriate quarters and leasing out the real property. The rentals on the owned property would be greater than the new rent payments to the business, thus increasing cash flow and the total return on business assets.

Non-operating Assets. In some instances, the business entity will own real property that is not used in the business or is used for personal purposes. As such, the property would be considered a non-operating asset or the use thereof, additional compensation, and handled accordingly in the valuation analysis.

Debt Capacity and Interest Rates. For many small businesses, the tangible and intangible assets may not provide much debt capacity. Locally, bankers will loan on only *tangible* assets at 50% to 75% of their value for about 5-7 years at interest rates of between prime and prime plus two. Commercial real estate, however, can usually command a lesser interest rate, a longer term (10-20 years) and a slightly higher loan to value ratio. When actual market financing for the business assets (exclusive of the real estate) is employed, the subject may not be able to carry the debt service.

Capitalization Rates. Another issue that arises is the difference in capitalization rates associated with real estate versus the business assets or the equity of the business. Although they differ by location, capitalization rates for non-institutional commercial real estate range from 8% to 15%, with averages ranging from 9.72% to 11.97%, according to the third quarter 1999 issue of Korpacz Real Estate Investor Survey.[1] The required rates of return for small businesses, before adjusting for any future growth, generally range from about 14% to 20% for invested capital and about 20% to 35% for equity. Long-term sustainable growth rates generally range from 3% to 5%.[2]

In the fourth edition of *Valuing a Business*, the authors state, "pretax income streams from direct investment in real estate tend to be capitalized at lower required rates of return than comparably defined pretax income streams for investments in non real estate oriented businesses. One reason for this is the lower perceived risk in the typical real estate investment. Another is that real estate investments often enjoy income tax deductions and credits that are not available to the comparable income stream earned by a business. …[They] may accept a lower rate of return from their [real estate] cash flow stream than they would accept from other assets because they expect extra return in the form of capital appreciation on the property. This is in sharp contrast to a business investment that includes machinery and equipment that will eventually lose value through wear and tear and/or obsolescence, or an investment that includes intangible assets that will become obsolete."[3]

If the real estate is a major asset of the business, applying the higher business discount or capitalization rate to the earnings of the company could understate the value of the business assets as a whole, specifically the real estate component.

Although there can be situations where the real estate is of a special use, unique and integral to the business operation, most businesses can be relocated to other similar real property, with few leasehold improvements or modifications. In most cases, the business is "portable," the real estate is not. In *Valuing Small Businesses and Professional Practices*, the authors state, "In valuing most small businesses and professional practices, it is often better to deal with the real estate separately from the value of the business or practice. For one thing, many sellers, who own the premises being occupied by the business are willing to sell the business or professional practice with or without the real estate. . . . Since many small businesses and professional practices do not own the real estate they occupy, balance sheet and income statement data usually can best be compared from one entity to another and to industry averages without real estate on the balance sheet."[4]

In *Handbook of Business Valuation*, David Bishop writes, "Most closely held businesses do not own their real property; therefore, most comparative ratio information with which you might compare would be based upon non owned real property. To leave the ownership of the real property in the business will then distort your company's ratios and make many of the comparative ratios analyzed meaningless."[5]

Comparability Problems. Another aspect of this issue is seen when the subject holding real estate is valued using valuation methods that exclude real estate, such as the owners discretionary earnings method and market approaches using BizComps and the IBA Market Data. To be able to properly employ these methods, the subject must be on a comparable basis with the data, and that data usually excludes real estate.

Valuation Adjustments

In situations where the real property is held in an entity separate and apart from the business, the rent and any related expenses need only be adjusted to FMV for the normal business use portion. In situations where the real property is held in the same entity as the business, the procedures are more complicated. In both cases, the FMV lease amount and FMV of the real property would usually be obtained from a real estate appraisal.

To value a small business separately from real estate that it owns involves several steps.

1. Adjust the balance sheets to remove the real property, the related accumulated depreciation and the related debt principle and accrued interest, if any.
2. Adjust the income statements to remove the real estate related depreciation and interest costs. If they are obvious, the other real estate related costs such as repairs, maintenance, property taxes and possibly utilities should also be removed.
3. Increase rent expense for the fair market value (FMV) lease of the business portion of the real estate occupied by the business. The lease amount should represent a rent that an arms-length landlord would charge if the landlord were paying the real estate expenses that were removed from the income statement. In situations where the repairs, maintenance, property taxes and other real estate related expenses (except for depreciation and interest) could not be removed from the income statement, the FMV lease amount should represent a triple net lease charge. A triple net lease is where the tenant pays all costs (repairs, maintenance, property taxes, utilities and

other costs, except principle and interest) plus pays the landlord a rent. The only payments the landlord makes are the debt service payments since the tenant pays for all other costs.

4. Value the business assets at the entity level using the appropriate market, income or asset approaches.
5. If the valuation assignment is to value a security interest in a partnership, corporation, LLC or other entity, the 100% entity value determined above must be adjusted since the real property is owned by the entity. To the value of the business assets, add the FMV of the real estate, including the non-business or non-operating portion and subtract the FMV of the debt, including any accrued interest.
6. Continue valuing the security interest as normal.

Any reasonableness checks (rules of thumb or justification of purchase tests) would be done on the entity asset value derived in step 4 above.

In situations where the real estate is not being put to its highest and best use, the FMV lease amount should represent that for a more normal or appropriate realty for the business rather than a rate based on the highest and best use of the actual real estate occupied. The value of the real estate at its highest and best use would be added to the value derived in step 4 above.

Conclusion

The complexities introduced by small businesses using or owning real estate range from minor to major depending on the circumstances. The solution, as discussed in this article, can be as simple as just adjusting the rent for non-owned real estate to fair market value. In more complicated situations, the solution involves recasting the balance sheet and income statement for various elements. By treating the real estate separately from the business as outlined in this article, the complications and potential problems involving realty are easily alleviated. ◆

END NOTES

[1] Korpacz Real Estate Investor Survey, Third Quarter 1999, PriceWaterhouseCoopers.

[2] Institute of Business Appraisers, *Discount and Capitalization Rates: Practical and Defensible Derivation Techniques for Small and Mid-Size Businesses*, 1999.

[3] Shannon Pratt, Robert Reilly, and Robert Schweihs, *Valuing a Business—The Analysis and Appraisal of Closely Held Companies,* 4th ed., McGraw Hill, 46.

[4] Shannon Pratt, Robert Reilly, and Robert Schweihs, *Valuing Small Business and Professional Practices*, 3rd ed., McGraw Hill, 101-102.

[5] David M. Bishop, "Recasting Financial Statements," *Handbook of Business Valuation*, Thomas West and Jeffrey Jones, 2nd ed., John Wiley & Sons, 102.