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# SCOPE OF WORK FOR SPECIAL-PURPOSE PROPERTIES

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## Value the Real Estate Only? . . . or the Going Concern?

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For years, one of the most common mistakes found in commercial real estate (CRE) appraisals has been using “General-Purpose” appraisal methods to estimate the value of “Special-Purpose” properties. Unfortunately, this can lead to funding loans that become problematic, resulting in sizable losses; yet it can be avoided if just a few warning signs are observed and some precautionary steps taken.

It is important to realize that the errors may begin at the time of the appraisal engagement. A borrower makes a loan application to a bank, and the bank, acting on behalf of the borrower, may unknowingly order the wrong type of appraisal. Their rationale seems logical: “Since our bank is only interested in making a real estate loan, it makes no sense to compel a borrower to pay extra or for us to require an appraisal that also values the business and equipment. We don’t need those values since we’re just lending on the real estate. ” (Note that it is actually *real property* but is often referred to as *real estate*.)

Also complicit in this potentially errant interchange is the appraiser. While many, if not most, CRE appraisers have not had the training or experience to value a Going Concern, most will gladly accept a job on the condition that if real estate value is all that is needed, they will just focus on that. Thus, both the appraiser and the bank may have unwittingly made mistakes that could ultimately cost the bank an unfortunate loan loss. The appraiser has the obligation to carefully work out the scope of work with the client, bringing their expertise to the discussion.

The problem stems from one primary misconception. For most general-purpose commercial properties, the business and the real property are separate entities; that is, the business can be moved to a different location, and the real estate can be easily utilized by a variety of different businesses. For example, a conventional retail building could serve as a donut shop today or an insurance office or dry cleaning establishment next month. Therefore, the real estate and the business can be separately valued, even by two different appraisers, for fees that might be less than the cost of a Going Concern appraisal.

However, for some CRE, the improvements are so unique that the real estate is entwined with the business operation; that is, people patronize the property because of its unique and specialized improvements--this is where they come to watch movies, play miniature golf, get their cars washed, buy gas, or spend the night. A change in ownership doesn't necessarily mean patrons will follow the former owner to a different location. Furthermore, the new owner will likely be in the same business, competing against the same competitors for essentially the same patrons. Finally, it is not easy or inexpensive to convert such facilities to other uses. These are "Special-Purpose" properties.

The source of income to sustain a Special-Purpose property (and determine how much a future buyer will pay) is directly tied to its profitability as a total package. Employing units of measurement such as price/SF or rent/SF are real estate valuation techniques that are not necessarily relevant for Special-Purpose properties. Rather, Going Concern valuation methods measure profitability for this specific business in this location with this mix of real property, tangible personal property referred to as furniture, fixtures and equipment (FF&E), and intangible personal property known as business enterprise value (BEV).

Consider one such common occurrence--the ground breaking of a new Costco or Sam's Club with a huge gasoline station out front that will suck the profit out of nearby gas stations, run them out of business if they are highly leveraged, and immediately lower their value substantially. A real property appraisal that relies on comparables about town and focuses on market rent or price/SF does not evaluate the impact of competitive forces (like a sizable reduction in gallonage sales) that could wipe out the business value and dramatically cut the real property value for many close-by competitors.

An appraiser looking for rental data and gas station sales will not be thinking about gallonage or potential new competitors. A Going Concern valuation would consider these factors; and once they are taken into account in the total value estimate, such an appraisal will conclude with an allocation of the Going Concern Value into its components, one being the real property value. By the way, most Going Concern appraisals use the Cost Approach to allocate how much value should be attributed to Real Property, FF&E, and Business Enterprise; but a traditional appraisal of the real property only commonly excludes the Cost Approach entirely, which is another significant shortcoming.

Problem loans stemming from non-credible appraisals can be minimized if some simple methods are employed to help both the banker and the appraiser clearly identify what a Special-Purpose property is and when an appraisal of the Going Concern is clearly necessary. To that end, the following six essential elements should be considered whenever there is a question as to whether the CRE might possibly be a Special-Purpose property.

1. **Apply These Tests to Determine if the CRE is Special Purpose**

2. **Not All Special-Purpose Properties Require a Going Concern Valuation**

3. **Locate and Obtain the Services of a Qualified Going Concern Appraiser**

4. **Reconcile the Historical Financials With the Projections**

5. **Allocate the Total Going Concern Value to RE, FF&E, and Business Enterprise**

6. **Avoid Engaging a CRE Appraiser to Value the Real Estate and a Business Appraiser to Separately Value the Business Enterprise**

Take a few moments to review this list when preparing the requested scope of work to obtain a bid for an appraisal. Sometimes appraisal bids vary by a considerable range because appraisers have quoted vastly differing scopes of work, some of which may not be adequate. Thus, this list could be helpful in ensuring that all bids are generally based on the same scope of work, and it should also prove helpful in reviewing the completed appraisal.

## 1. Apply These Tests to Determine if the CRE is Special Purpose

A property should be deemed Special Purpose and valued as a Going Concern when it has been developed in a manner that renders its improvements uniquely and specifically suitable for a certain type of business operation in a specific industry. It is crucial to consider the question: "If the business operation were to fail under its current ownership and pass to a subsequent owner, would the new owner also be constrained by the improvements to operate a similar business in the same industry (without substantial conversion costs)?" See also the general discussion at the beginning of this document.

If so, the factors of supply and demand for that *business type* in that industry will have a very large impact upon the value of those *real property improvements* and is a necessary consideration in the valuation process.

Therefore, the first step in deciding if a Going Concern Appraisal is necessary is to determine whether the CRE is Special Purpose. Here are the common tests:

- Is the property type normally owner-operated as part of a business versus rented?
- Does the property require a skilled level of specialized management expertise to operate effectively?
- Does the property have limited alternative uses without costly modifications?
- Will the property likely be sold with the business operation?
- Will the price of the property be linked to the business performance?
- If the property is leased, is the lease tied to the business performance? (Are such properties typically rented, and are there many rent comparables?)
- Would it be difficult to determine a market-wide vacancy factor for this type of property?

If several of these questions are answered in the affirmative, it is likely that the CRE is a Special-Purpose property. Common examples would include hotels, motels, gas stations, car washes, truck stops, golf courses, boat marinas, movie theaters, and nursing homes, to name a few.

## 2. Not All Special-Purpose Properties Require a Going Concern Valuation

Just the determination alone that the CRE is a Special-Purpose property does not necessarily require a Going Concern appraisal. Properties of this nature are sometimes leased or built-to-suit with a long-term lease. A fast food restaurant on a build-to-suit pad at the corner of a shopping center is a common example. If the tenant is strong, the lease still has many years to run, and a different type of fast food operation could easily utilize the improvements, a more conventional real estate approach using leased fee valuation techniques could be practical. A cold-storage building is another typical example.

As a safety precaution, however, if there is any way the owner of the leased fee interest can obtain an indication of the operating income from the tenant, it will prove useful to see if the tenant's business is in a healthy position relative to covering the lease payments. If the tenant is struggling to pay the rent, this tenancy may be short-lived, and the owner may end up with unoccupied CRE that is very much a Special-Purpose property.

This has actually happened. Some very significant lending losses were sustained awhile back when a large bank made loans to a jobber who owned numerous gas stations that were all leased to individual dealers <u>on short 3-year leases.</u> Since the businesses were all leased (even though they were all short-term), the bank reasoned that the appraisals could be for the real estate only. Thus, they were given to a real estate appraiser who just capitalized the contract lease income at real estate overall capitalization rates (OARs) using real estate valuation techniques. In so doing, the stations were dramatically overvalued, allowing the jobber to take on too much debt.

When gas prices escalated and volumes fell, the dealers failed and quit their leases, leaving the jobber with vacant stations; thus, the bank ended up with large portfolio of vacant properties that were liquidated at less than half the values reported in the appraisals. Securing valuations of the Going Concerns (with some sort of examination of the business operations) might have spared the jobber bankruptcy and the lender millions of dollars in loan losses from overly optimistic value opinions. Unfortunately, neither the appraiser nor the lender was aware of this phenomenon. *By the way, the drop in value suffered when a gas station or car wash closes down is usually very dramatic; if you have a problem property, it may well be worthwhile to do what it takes to keep it operating unless economics dictate that it should in fact be shut down permanently. There are consultants who can assist in such cases.*

For properties where the improvements are small compared to a large land area or they are of an older vintage in a dense urban area, the majority of the value is clearly in the land component, not the improvements. When this happens, a considerable amount of appraisal expense can be prudently avoided by structuring a land-only loan, thus obviating the need for an appraisal of the Going Concern. In such cases, a conventional CRE appraisal is typically quite suitable.

## 3. Locate and Obtain the Services of a Qualified Going Concern Appraiser

If most of the answers to the questions listed in Item #1 above are positive and the responses to the exceptions in Item #2 are negative, it is time to start thinking about getting an appraisal of the Going Concern. The Income Capitalization Approach is typically the most important approach to value; but an Income Approach in a Going Concern valuation goes beyond the study of rental rates and vacancy factors. Instead, it will focus on an analysis of the closest and most directly competitive businesses in the trade area. Estimates of gross and net revenues are measured and compared to the operating history of the subject. Industry multipliers and Going Concern OARs or net income multipliers (NIMs) are applied to gross profits and projections of EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amortization). The result is an estimate of the total value of the Going Concern, the last step of which is to separate or allocate the total to its component parts.

Crucial to this process is finding and retaining the services of an appraiser who has considerable experience in the specific industry and relevant knowledge of and experience with Going Concern valuation techniques. There have been so many problems caused by the actions of otherwise-competent appraisers getting in over their heads in this complex niche that some of the major appraisal organizations began to offer courses that specifically deal with analyzing and separating the components in a going concern. You should ask potential appraisers if they have taken a course similar to “Fundamentals of Separating Real Property, Personal Property and Intangible Business Assets” offered by the Appraisal Institute. The American Society of Appraisers also offers a relevant course.

If this is an SBA loan, the appraiser must validate that they have performed at least four similar appraisals in the last 3 years. They must recognize that the total going concern value is related heavily to the income potential of the property and base the entire methodology on that fundamental concept. The typical appraiser may not even know what type of information to request from the borrower or what to research in the field, let alone how to perform the actual analysis process. Some appraisals include many pages of generic “boilerplate” information about the industry, state, county, and city but may not even discuss the historical expenses in detail. It would be worthwhile to have appraisers send samples of going concern assignments before you approve them for such work. As you read through the sample, have in mind some of the issues raised below. Make sure that somewhere in any appraisal report dealing with a Going Concern there is a conclusion of the “As Is” Market Value of the Real Property (or real estate).

(It is typically satisfactory for an appraisal to include hypothetical conditions when relevant, but there should not be any such conditions specifically related to the "As Is" Market Value of the real property.)

## 4. Reconcile the Historical Financials With the Projections

The appraiser should thoroughly interview the owner about the prior history of the subject. There may be pointed questions about wash volumes, gallons sold, store margins, or why an expense increased or decreased a bunch from one year to the next, for example. This is considerably more detail than is needed for an owner-user industrial building, so some borrowers become annoyed. If possible, inform him at the beginning of the process that this is a requirement of USPAP and will result in the *most credible* value conclusion (not necessarily the *highest*).

If the property was recently constructed by the owner, attempt to obtain an estimate of the total cost and, if possible, a copy of the appraisal used for the construction loan. If it was recently purchased and remodeled, obtain the prior purchase price and the cost and extent of remodeling. This information should be provided to the appraiser.

While USPAP requires an appraiser to report on and analyze any prior sale transaction (date and amount) involving the subject within the past 3 years, try to expand this further, perhaps to 5 years. And, if the current owner has owned the property longer than 5 years, the appraisal will hopefully include the date and price paid by the current owner. (USPAP allows a financial institution to impose even stricter requirements that carry the same weight as normal USPAP requirements. Thus, an appraiser can simply explain to an otherwise-reluctant owner that obtaining a complete history is a federally mandated appraisal requirement.)

However, if there are reasons the owner believes the price he paid did not reflect value at the time of purchase or is completely irrelevant now, the appraiser should invite the owner to offer those explanations and then include them in the report. A common example is the change in value resulting from completion of a significant renovation or addition. Finding out how much was spent in the effort and adding that to other issues of reconciliation (like a time adjustment) could offer insightful clues to current value.

If the property is currently under contract, the appraiser should attempt to determine if the current contract (or most recent transaction) was a true market transaction (arm's-length with an independent seller/buyer and a reasonable marketing time). If a past purchase price was significantly different than the current estimate of value, especially if the variations do not also correspond with changes in the marketplace or to the property, the explanations offered by the owner or seller should be reported and an attempt to reconcile them with the current estimate of value should be made. If the property has been listed for sale during this period, attempt to obtain the broker's contact information so he can be interviewed and the listing price, time on market, offers if any, and the broker's opinion of value can be reported. If the seller or owner is uncooperative, let the appraiser know.

The appraiser should be provided 2-3 years of historical income and expenses in a standard accountant's format. Tax returns typically are simplified and thus do not provide enough detail and may also mix multiple properties. However, it is worthwhile to try to compare the primary revenue and expense totals between tax returns and accountant's statements. The tax returns have been submitted and certified as being truthful, with legal implications for "mistakes." There should be reasonable correlation between the various statements.

**5. Allocate the Total Going Concern Value to RE, FF&E, and Business Enterprise**

The value of the Going Concern represents the total value of all the assets, including land and buildings (real property), FF&E, and BEV. Therefore, the Going Concern Value sets the upper limit to value for the real estate since "a part" cannot be worth more than "the whole." (The one exception is that if land value is higher than the value of the Going Concern, the specialized improvements and business operation are economically obsolete; in that case where redevelopment is supported, the value of the property is the land value less demolition costs.)

From an estimate of total Going Concern Value, the Cost Approach is typically employed to allocate between Real Estate, FF&E, and BEV. The appraiser should apply physical, functional, and external depreciation to the building improvements and equipment as is indicated. Real property must be first to receive an economic return after operating expenses; and in some cases, there may not be enough residual income beyond operating costs and a suitable return on the real estate to justify any meaningful business enterprise value. Also, watch out for the very common mistake of valuing the real estate alone, using just the Cost Approach. Appraisals like this may overvalue a property and are a potential cause for a troubled loan because an astute appraiser was not engaged to determine if there was sufficient demand.

Some appraisers may use the Sales Comparison Approach to estimate the real property value. The problem is in finding adequate sale comps that are truly relevant and don't include an unspecified amount of intangible value. The physical differences can be very substantial; and as long as the potential for external depreciation is considered as discussed above, the Cost Approach is recognized as the best of non-perfect options for isolating the value of the real property (and FF&E).

**6. Avoid Engaging a CRE Appraiser to Value the Real Estate and a Business Appraiser to Separately Value the Business Enterprise**

For businesses located in General-Purpose properties, this methodology will work fine; but for Special-Purpose properties, this is a dangerous scenario. In many cases, having a Special-Purpose property appraised by two independent appraisers, one for the real estate and another for the business, and then adding the two values together will result in an overvaluation, often by a significant amount. Unless the two appraisers are in collaboration, there is a significant possibility that they will double-count the income, and it is also possible that they might undervalue the assets.

For example, the mandate for the real estate appraiser will likely be to value only the real estate ". . . because we already have an appraiser to value the business." However, this returns us to the same problem discussed earlier--overvaluation of Special-Purpose properties by appraisers using Real Estate valuation methods instead of Going Concern methods.

The following example is one illustration of how this could occur. A real estate appraiser works hard to find rent comparables for, say, a gas station that looks great but is not doing that well performance-wise. He/she may find a few rent comparables or very likely will instead need to estimate rent from reasonable rates of return for the land and the improvements based upon depreciated costs. However, he won't have any sense of how much external depreciation (obsolescence) there might be due to competitive market forces (like the brand new supermarket fuel center a mile away that has reduced the subject's income by a third).

While a skillful Going Concern appraiser will be looking for significant changes in the supply and demand for gas stations and will look at the operating statements of the business, the real estate appraiser will be looking for rent comparables. Using his best effort, he will estimate market rent and convert that into an estimate of real property value using the usual Income Capitalization Approach by applying an overall capitalization rate or net income multiplier. He won't know whether the Going Concern operation is able to generate enough net income to pay his estimated market rent. It may be that, in fact, 100% of the net income (EBITDA) is needed to cover the cost of real property with no residual cash flow to the business component--or worse. In essence, his estimate of value may be too high.

Enter the business appraiser, operating independently of the real estate appraiser. Coming at it from the other direction, he might allocate, say, 10% to 30% of the net income to the business based on published guidelines and value the business component accordingly. Thus, he leaves the remainder (say 80%) for the real estate component. It's not hard to miss the 20% gap in this illustration (and the gap could be worse in some instances!). The 20% allocation to business value should be 0% in this example. Plus, the real property value may have been overstated.

The errors could also run in the other direction, where the real property appraiser estimates market rent from whatever rent comps can be found, not really knowing the relative strengths of the various locations (which would be strongly indicated by the amount of BEV supported). If he underestimates market rent with inferior comps, the real estate value is lower than could be supported by a better understanding of the big picture.

## Conclusion

The most common property types that fall into the Special-Purpose category are hospitality, petroleum (gas stations and C-stores), and car washes. Hospitality properties are a bit different in that their income is more directly related to size (a certain amount of income per day per room) than a car wash or gas station. Also, as a rule, the percentage of BEV contributing to the total Going Concern value tends to be higher for the latter. Therefore, deducting the non-realty portions may represent a larger deduction for gas stations and car washes, which makes them more likely to need the treatment of an appraiser with specialized expertise as described above.

However, when it comes to reviews, no appraisal is perfect, and neither are the data available to the appraiser for use in the valuation effort. When a report is mostly on target but some areas of analysis are weak, less credibility should be placed on the value estimate, increasing the potential variance from that conclusion. This might affect your applied loan-to-value ratio, for example.

If most of the areas listed are weak and the appraiser hasn't provided credible explanations of the attempts made to deal with relevant issues and the reasons they weren't successful, the appraisal is probably not reliable. In that case, the bank has several alternatives. The appraisal could be sent back to the appraiser for corrections, or it could be sent out to another licensed CRE appraiser who has competence in performing Standard 3 Technical Reviews on properties of this type, with your own concerns noted. In some extreme cases, a judgment must be made about whether the appraiser has enough competence or expertise in this area to make the appropriate corrections. As a last resort, a new appraisal must be ordered. Hopefully this discussion helps reduce the likelihood of that.