Untangling the Mess: Separating the Real Property from the Tangible and Intangible Personalty

By David C. Lennhoff, MAI, CRE, FRICS

American College of Real Estate Lawyers

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Introduction

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 paper will examine the strengths and weaknesses of the various methods advanced for making the allocations.

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

² Ibid., p. x.
resources from the next most rewarding alternative use.” 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 personality, 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, 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).

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.

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4 Ibid., 6-107-110.
Indications of the Possible Existence of Intangibles

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 intangibles 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, healthcare, 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 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. Another weakness is the fact that few

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5 Ibid., 8-138.
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