Fall 2007

THE INSTITUTE OF BUSINESS APPRAISERS, INC.

Business Appraisal Practice

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Editor's Column – Business vs. Real Estate Cap Rates

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It is not uncommon to see an inexperienced business appraiser, particularly one who has a real estate background or is familiar with commercial real estate properties, use a real estate capitalization rate to value a business entity. When this occurs, the business is typically significantly overvalued.

For many years it seems like the capitalization rate (cap rate) that was used for many real estate commercial properties was ten percent. It is still used as a "rule of thumb" by many real estate brokers and property owners. Over the last few years, we have seen cap rates in many real estate appraisals drop significantly from this old bench mark, resulting in higher values.

Just what is a cap rate and what does it measure? A cap rate represents the percentage applied as a divisor to a one-year income stream that is indicative of the value that both a typical buyer and seller would agree upon. In simple terms, it is the rate that a buyer requires for the annual income from a property, plus the profit (typically from appreciation) that the buyer expects from an eventual sale of the property. It is critically important to realize that the cap rate includes both annual income and anticipated future appreciation!

The income stream used in real estate valuations is net operating income – a pre-tax income stream. The income stream used in business valuations is net cash flow – an after-tax income stream that is also adjusted for non-cash expenses, capital expenditures, changes in working capital and changes in long-term debt. Cap rates applied to value real estate and those applied to business income streams are very different. They simply cannot be used interchangeably at all. However, often we see a real estate appraiser or someone familiar with real estate appraisals try to value a business using a real estate cap rate. When a business appraiser tries to value a real estate property, the cap rate is, of course, generally ten percent.

Business and real estate cap rates also come from different places. A real estate cap rate is often "extracted from the market," meaning real estate appraisers collect a number of sales for which income information is known so that cap rates can be calculated. Using a number of similar property sales, the "market" cap rate can be extracted. The only problem with this approach is that it essentially guarantees that the sales comparison approach and the income approach are going to match because the same data is used for both – this could be either good or bad. What it does mean is that when the same data is used to develop both approaches, the approaches do not "check" each other – they give you the same answer. We generally use another method called the band of investment approach to "check" our data to see if it is reasonable. The band of investment techniques use equity and mortgage investment rates to estimate a cap rate for a property. This tool also has a problem: it is extremely sensitive to small adjustments and thus answers can easily be skewed if the appraiser is not careful. Business cap rates are typically "built-up" using a risk free rate, a rate for the overall stock market as a whole, a size premium for smaller publicly traded stocks, and then a subjective specific company risk premium estimated by the appraiser. This methodology is also extremely sensitive to small adjustments. This is why other business appraisal methods must be used to support conclusions reached using a cap rate.

If this discussion makes you uncomfortable, it has accomplished its purpose. A valuation constructed using only one approach is often difficult to support. This is why generally three approaches to value: the market or sales comparison approach, the cost or asset approach, and the income approach are used to estimate the value of a property or a business interest.

The following examples illustrate simple applications of cap rates for both a business and an income generating commercial real estate property:

Commercial Property Example

Gross Income	$100,000		
Vacancy & Collection Allowance	(5,000)		
Effective Gross Income	95,000		
Operating Expenses	(28,500)		
Net Operating Income	$66,500		
Net Operating Income	$66,500	=	$700,000
Capitalization Rate	9.5%		
Value Conclusion	**$700,000**		

Business Example

Total Sales	$1,000,000		
Cost of Goods Sold	(250,000)		
Gross Profit	750,000		
Operating Expenses	(615,000)		
Net Operating Income	135,000		
Less: Provision for Income Taxes	(54,000)		
Net Income After Tax	81,000		
Plus: Depreciation	75,000		
Less: Capital Expenditures	(50,000)		
Change in Working Capital	30,000		
Change in Long-Term Debt	(15,000)		
Net Cash Flow	$121,000		
Net Cash Flow	$121,000		
Increased by Long-Term Growth Rate	1.03		
Future Net Cash Flow	$124,630		
Future Net Cash Flow	$124,630	=	$692
Capitalization Rate	18%		
Value Conclusion	**$700,000**		

In this example, both the commercial property and the business have the same value of $700,000. The cap rates are very different numbers and they are applied to different income streams, yet the values are the same. Does this mean that an investor would look at these two investments as identical? Certainly not. Although the indicated value is the same, they would each very likely have completely different risks and potential benefits associated with them.

It is important to understand where a cap rate comes from and its applicability to the income stream to which it is applied. If the process is not understood and applied correctly, value conclusions will not be meaningful.

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Please submit articles for ***Business Appraisal Practice*** by email to: prh@hydevaluations.com.