PAUL R. HYDE
EA, MCBA, ASA, MAI

HYDE Valuations, Inc.

We Value Both Real Estate and Businesses
Including Machinery & Equipment

APPRAISERS:
PAUL R. HYDE
SHAWN M. HYDE
BRIAN D. HYDE
JOSEPH PHELON
MATT BURTON

May 2012

The Income Approach

An appraisal is an informed opinion as to the value of something. For example, real estate, a business interest, and equipment are common subjects of appraisals. There are three basic appraisal approaches: the asset/cost approach, the market/sales comparison approach and the income approach. Each approach includes a number of appraisal methods that may be employed and each method has some strengths and weaknesses. In this article, we are focusing on the income approach.

The income approach, in a nutshell, is calculating the value of a subject based its expected future benefits. In other words, this means that the value can be based on the present value of the future expected income stream associated with the subject which could be:

a) a regular periodic income stream with a sale expected in the future,
b) irregular periodic payments with a sale expected in the future,
c) no payments of any kind with a sale expected in the future, or
d) periodic payments with the subject being used up and no future payment or even a negative future payment, i.e. a cost to reclaim a gravel pit or some other depleting property.

There are two basic methods (with numerous wrinkles for each) for calculating the value of a subject using the income approach. Which one is used depends on the nature of the expected future income stream. If the asset generates regular periodic income (a relatively stable income stream), and is expected to be sold for a profit sometime in the future, the value can usually be determined by dividing the expected annual future return by a capitalization rate. If the asset generates varied annual income (or no periodic income at all), and is expected to be sold at some time in the future, than the present value of each year's income stream would be determined in today's dollars (the present value) by use of a discount rate with the estimated future sales price also determined by use of a capitalization rate and its present value also discounted to the present. A similar process is followed for subjects which have no expected future sales price (for example, the gravel pit mentioned earlier).

Determining which method to use is a fairly simple process – the expected stability or instability of the income stream is what determines the method used. Calculating either the capitalization rate or the discount rate is the most difficult part, as it is considered to be "where the rubber meets the road." Capitalization and discount rates should come from the "market", however, the market is often not clearly measurable which results in a number of approximation techniques that may be used. A mistake in the determination of the rate used can seriously impact the value conclusion. For example, if the appraiser uses a capitalization rate that is too small, the subject will be over-valued. The opposite is also true and the use of an over-sized capitalization rate will under-value the subject.

How the discount or capitalization rate is estimated usually determines the appropriate income stream that should be used. Knowing when to use net operating income, net income before tax, or net cash flow (which is an after-tax, after adjustments for depreciation, amortization, capital expenditures, changes in working capital and changes in long-term debt), EBITDA (earnings before interest, taxes, depreciation, and amortization), or some other income stream with the selected discount and/or

capitalization rate is critically important. Use of the wrong income stream with the selected rate yields a meaningless value conclusion.

It is vital to understand the limitations and strengths of each appraisal approach and the various methods with each approach with respect to the assignment. While the income approach is a valuable tool, it is best utilized in conjunction with the other approaches. The appraiser should carefully explain the data used, the application of the appraisal methods, and the degree of confidence that should be placed on the indication of value from that method. Depending on a large variety of circumstances, the confidence in any particular appraisal method can vary from very low to quite high. If possible, methods from more than one appraisal approach should be used in order to provide support for conclusions from methods in other approaches. This can be likened to a three legged stool – with three legs the stool provides a stable and comfortable place to sit; with one or two legs under a stool, a person is much less comfortable. An appraisal supported by methods from all three appraisal approaches is usually much more reliable than one with only one appraisal method from one approach. Of course, the appraisal of some subjects simply cannot be done with more than one approach – these types of appraisals should be scrutinized more carefully as they simply have no checks and balances to support the conclusion.

Valuations play a part in all strategic transactions, tax, and many litigation matters. For additional information or advice on a current situation, please do not hesitate to call. **We value real estate, businesses, and personal property including machinery & equipment.**

Sincerely,

Paul R. Hyde, EA, MCBA, ASA, MAI
Enrolled Agent – Enrolled to Practice Before the IRS
Master Certified Business Appraiser
Accredited Senior Appraiser – Business Valuations
Designated Member – Appraisal Institute (MAI)
Certified General Real Estate Appraiser
Accredited Equine & Livestock Appraiser

504 Grove Avenue • P. O. Box 9 • Parma, Idaho 83660 • (208) 722-7272
www.hydevalutions.com Email: prh@hydevaluations.com