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Failure to Match Methods with Value Needed

One of the biggest problems I often encounter when reviewing appraisals of virtually any type is that appraisers sometimes fail to match the appraisal method conclusion with the value they are trying to determine. This occurs in a wide variety of assignments and generally happens when an appraiser is following some "cookie cutter" system that was learned rather than thinking and analyzing what they are doing. For example, business appraisers are usually asked to determine the fair market value of the equity in a company. They tend to get used to looking at all assignments as valuing the equity – i.e. the fair market value of the assets less the fair market value of all of the liabilities. However, periodically, they might be asked to value the assets that would typically transfer in a sale – for example, for a lender who is looking to determine the value of the assets being purchased as collateral for a loan. When the fair market value of the assets that normally transfer in an asset sale is the value conclusion needed, a number of the typical business appraisal methods MUST be modified. If they are not, the value conclusion simply doesn't make any sense and is not supportable.

Here are some of the business appraisal methods commonly used and the type of value they generate:

- Adjusted Book Value Method – value of the Equity
- Liquidation Method – usually Equity; can be Asset
- IBA Data Private Company Transaction Methods – value of Assets
- Pratt's Stats Private Company Transaction Method – can be either Assets or Equity; the appraiser must check each of the underlying transactions used as they are labeled either an Asset sale or a Stock sale (it often makes a big difference!)
- Guideline Public Company Method – value of the Equity
- Public Company Transaction Method – value of the Equity
- Capitalization of Earnings Method – value of the Equity
- Discounted Future Earnings Method – value of the Equity

When appraisal methods that result in the value of the Equity and methods that result in the value of the Assets are both used in an assignment, adjustments from Equity to Assets or Assets to Equity for the methods that result in the opposite conclusion from that desired must be made. They sometimes are not, resulting in an incorrect value conclusion.

A similar problem is frequently encountered when valuing machinery and equipment. There are a number of different standards of value that might be needed. For example,

- Fair Market Value, Orderly Liquidation
- Fair Market Value, in Place and in Continued Use
- Fair Market Value, Installed
- Fair Market Value, Forced Liquidation

The use of comparable values from similar equipment sold at auction is typically used when the value needed is Fair Market Value, Orderly Liquidation. However, if this is the method employed when the value needed is Fair Market Value, in Place and in Continued Use, the conclusion will be wrong as the comparables being used would not be directly applicable to the value being appraised. Of course, in some cases, such information may be all that is available. Should that be the case, the appraiser must "convert" the data to the applicable needed value conclusion.

In real estate appraisal assignments, market value is generally the desired conclusion. Most assignments call for the value of the real property without any debt, i.e. an asset sale value. However, some assignments also want a leased fee interest, not a fee simple interest (the most complete form of ownership). In other words, the assignment might be calling for the value subject to a specific lease. If the lease rate is relatively similar to the market rates, the leased fee value conclusion will often be similar to that of a fee simple value. When either a significantly lower or higher than market rate is in place, things get more complicated. I recently got a call from a business appraiser appraising an entity that owned, amongst other things, a piece of real property subject to a long-term lease with fifty years remaining, at a fixed rate that is currently below market rates. He asked me why the real estate appraiser used current sales of similar properties to arrive at the value. I informed him that it was likely that the appraiser made an error – the leased fee interest of such a property was very likely to be much less than its current fee simple value. Conversely, occasionally I see a report of a property with a long-term lease that is significantly higher than the market rate --- in a situation such as this, the value cannot simply be determined mathematically; the possibility that the tenant may buy out the lease or simply walk away must be considered. There is likely higher risk associated with receiving continued payments on an above market rate long-term lease than a market rate lease. Of course, a long-term below market lease is less risky – as it is more likely that the tenant will pay such a lease than a market rate lease.

Valuation is both an art and a science. Appraisers get into trouble when they fail to use common sense and when they follow some cookbook supplied to them instead of understanding and thinking about what they are doing.

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 livestock and machinery & equipment.**

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