

# Chapter 8: Asset Valuation (Real Estate)

**At times, real estate may be the largest item of fixed assets on the balance sheet. The two most important items to consider are the market value of the building if it is part of the transaction, or the lease if the building is not part of the transaction.**

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## Introduction

When valuing a business and reviewing the real estate component, you need to look at one of three things, depending upon whether the seller owns the facilities or leases:

- (1) The value of the facility (if the seller owns the building/buildings).
- (2) The value and duration of the lease (if the seller does not own the building).
- (3) Some combination of the two (if the facility will be leased by the seller, the fair rental rate should be determined).

The lease and real estate facilities of a business are the most important items to review before valuing or purchasing a business. It is critical to know how much land there is, how much building space there is, whether the property is owned or leased, and whether it is for a market value or a liquidation value. The building and land characteristics of the property, as well as its market supply and demand should be accurately determined.

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## Valuing the Real Estate Assets

The best way to understand real estate valuation is through the use of an example.

**Valuation Example**

Throughout this chapter, we will present a quick valuation of an industrial building. This analysis will assist the reader in understanding how this asset fits into the overall business valuation. Many steps have been skipped, but the issues and analysis will give a buyer/seller or analyst a good “back of the envelope” indication. The most important specifics of this building can be seen in Table 8-1.

**Table 8-1: Land/Improvement Statistics of Example**

Item	Statistic
Location	123 Dupont Street Ontario, CA
Interest Valued:	Fee simple interest (company owns building and does not lease)
Land Size and Shape:	6.87 acres, 299,257 sq. ft.
Zoning	M1 (manufacturing)
Tax and Assessment Data	1.0091% of assessed value, plus \$29,472 in special assessments
Gross Building Area:	85,080 square feet
Year Built	This year
Construction Type:	Good, Class C Construction
Parking	131 spaces
Amenities	Rail Access

Before reviewing the different techniques of valuing a building, it is important to understand the various ownership interests in real estate, as well as the critical and unique building and land statistics.

**Ownership Interests**

There are four general interests in real estate:

- (1) fee simple
- (2) leased fee
- (3) leasehold
- (4) partial interest

Fee simple interests are the most common, meaning that the property is not encumbered by any other interest or lease. This interest is most used when valuing an owner user property where there are no tenants, and the owner (seller) also owns both the land and building.

A leased fee interest means an ownership interest held by a landlord, but leased to others; the rights of the lessor (landlord) or the leased fee owner and leased fee are specified by contract terms contained within the lease. This interest is involved mostly when valuing income producing property with leases such as industrial, office buildings or retail centers.

A leasehold interest is defined as the right to use and occupy real estate for a stated term and under certain conditions, conveyed by a lease. This interest is generally involved when valuing a land lease or the lease of a tenant.

Finally, a fractional interest is an interest in either of the three interests seen above but is less than 100%. An example of this would be a house in which three people have one third interests. Fractional interests are described in Chapter 11.

**Table 8-2: Important Land Characteristics**

Item	Description/Comments
Location:	Get the address (look at title report/tax bill)
Assessor's Parcel Number:	Needed to establish basic tax identification and other statistics. Generally found on the tax bill.
Size and Shape:	There are 43,560 sq ft in one acre. This is a critical factor since you need to know if there is enough room for expansion, if your parking is less than the overall market, if the turning radius for freight delivery is inadequate, or if there is excess land which is an additional asset for the balance sheet.
Ingress/Egress and Exposure:	If you cannot access the property, or are subject to a short term easement, then the value is much lower.
Adjacent Properties:	Is the property next to a toxic dump or gas station?
Topography:	Are there problems here? A hard rain or earthquake may make a building slide down a hill. Some buildings gradually shift down a slope.
Drainage and Storm Water Control:	Will the building float away? You may need flood insurance.
Hazards:	What was the building previously used for? Is it on top of a fault line (earthquake)? Is it contaminated by toxins (lead, methane)?
Easements, Restrictions, and Encroachments:	Does the title report flag any issues? The seller may not even know about these, such as the right for a neighbor to drive across your property.
Utilities:	Will you have to dig a ditch for sewage, water, or electricity, and pay for two miles of digging and engineering to make the building operational?
Zoning Provisions:	This is a big one. It is absolutely critical to find the existing zoning code. If your building burns down can you re-build the same structure? In most cases you can't. If you currently run a manufacturing business and the zoning has been changed to retail, then this may be a problem. Check to see if you need a conditional use permit (CUP) for your business.
CC&Rs/Private Restrictions, Governing Use:	Nail these down. These usually appear in the title policy and show any restrictions on the use of the property.
Tax and Assessment Data:	Are you being over assessed or under assessed? Also, you want to find out when the next assessment is for the county. Your taxes may double.

## Land and Building Analysis

Before valuing anything, one must know the building and land parcel sizes. First, the site improvements need to be reviewed. The general characteristics for a land parcel can be seen in Table 8-2. Critical improvement characteristics are seen in Table 8-3.

**Table 8-3: Important Building Characteristics**

Item	Comments
Gross Building Area:	Get the correct square footage; a second story or mezzanine is often built by a seller in an industrial building. The commercial real estate market may not give any value to this additional floor or may give only partial value. You do not want to end up paying top dollar for this additional floor.
Exterior:	Concrete, wood?
Foundation:	Is it flat, and can it withstand inventory stacking? If so, how high?
Roof:	Do you need a new one? This can be expensive! How old is it?
Air-conditioning/Heating:	Same as the roof.
Plumbing:	Do you need new plumbing?
Electrical:	Do you need to spend more money to upgrade the system?
Fire System:	This varies based upon the building use. Do you have a sprinkler system or are your employees and store materials going to burn? If not, how is this going to affect your insurance premiums? Will the fire department allow you to operate in the existing facility?
Parking:	Critical! Are there enough spaces for the use of the building (distribution, manufacturing, etc.) This has to comply with zoning, unless grandfathered in.
Loading Doors:	It could make or break an operation.
Ceiling Height (Truss Height):	Is the ceiling high enough for more stacking of inventory? How high will the fire department allow?
Environmental:	Asbestos, etc.? Are you purchasing an off balance sheet liability? Are there clarifiers in the building?
Age:	Is the building about to fall over, or has it been maintained?
Functional Obsolescence:	Are there problems with the building which impact the operation of the business? For example, if you are to lease or buy a building and there is no air conditioning system, then this is a problem. If you are to lease or buy an industrial building and you need 18-20 feet for inventory stacking, and the building only has a stacking height of 15 feet, then you will need to eventually lease more space in order to store inventory. Ask a commercial broker if you are not sure.
Deferred Maintenance:	This is critical. You want to know going into a deal whether you need to pull out your checkbook for a new roof, electrical wiring, earthquake retrofitting, asbestos abatement, plumbing etc. Get a good structural engineer and contractor when in doubt (even when not in doubt).

### Market Analysis

The appraiser should then determine the vacancy rates in the area, the amount of space which is being built or planned, and whether vacancy rates and rental rates are decreasing or increasing as a result of supply and demand imbalances. This information may be obtained from real estate brokers or from

appraisers. Also, contact the city planning department for additional information on future development. One should not get into a long term lease, only to learn that better and new space is about to be built, or a competitor is about to locate next to you.

You can get much of this information on-line from three commercial real estate brokerage companies. These companies and their respective web sites can be seen in Table 8-4.

**Table 8-4: Market Analysis Sources**

Commercial Real Estate Company	Web Site
CB Richard Ellis	<a href="http://www.cbrichardellis.com">http://www.cbrichardellis.com</a>
Cushman & Wakefield	<a href="http://www.cushmanwakefield.com">http://www.cushmanwakefield.com</a>
Grubb & Ellis	<a href="http://www.grubb-ellis.com">http://www.grubb-ellis.com</a>

If the total amount of industrial space in a given market is 54,200,000 sq. ft., with the vacant space being 3,252,000 square feet the vacancy rate is 6.0%. It therefore seems like a healthy market and may indicate stable values. On the other hand, the market may have greater demand than supply, indicating that you may be paying top dollar.

**Market Analysis Example**

**Valuation Approaches**

After gathering basic statistics on the building and land which you are appraising, the appraiser may then apply different approaches to valuing the property or properties. There are three basic valuation approaches: (1) the Cost Approach; (2) the Direct Comparison Approach; and, (3) the Income Approach. These approaches are more comprehensively described in Figure 8-1 on page 178.

The Cost Approach calculates either the reproduction cost estimate of the subject property improvements (maintaining comparable quality and utility), or the replacement cost. Losses in value are then subtracted from this value. Losses are from depreciation, age, wear and tear, functionally obsolete features, and economic factors affecting the property. The net value (cost less depreciation) is then added to the estimated land value to provide a total value estimate.