When Do I Need an Appraisal of My Restaurant's Real Estate?

By Richard D. Williams, May 10, 2004

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Real estate appraisers are frequently asked to give examples of when it is appropriate to have an appraisal performed to determine market value or investment value. The perception of most people is that appraisals are used for financing only. However, valuations of restaurant real estate are performed for a variety of reasons, and serve a variety of purposes. There are some common elements to all appraisals because appraisal reports must comply with the rules of the Uniform Standards of Professional Appraisal Practices ("USPAP"). The purpose and the intended use of an appraisal are included in the list of items that must be set forth in an appraisal report. The contents of the appraisal report may be affected by many factors, including the intended use of the appraisal report, although regardless of the use of the appraisal, the appraiser is obligated, under USPAP, to provide an objective opinion of value.

USPAP also requires that reports set forth the type of value and the definition of value. Typically, regardless of the reason for the appraisal, the value being ascertained will be the "market value." Market value is frequently defined as "the most probable price, as of a specified date, in cash, or in terms equivalent to cash, or in other precisely revealed terms, for which the specified property rights should sell after reasonable exposure in a competitive market under all conditions requisite to a fair sale, with the buyer and seller each acting prudently, knowledgeably, and for self-interest, and assuming that neither is under undue duress." Other types of value which be applicable to a valuation of restaurant real estate are "use value," "investment value," "going concern value," "assessed value," and "insurable value." The type or types of value to be reported in an appraisal of restaurant real estate will be determined, in part, by the purpose and use of the appraisal. Accordingly, it is important that the appraiser, prior to beginning a valuation, have a good understanding of the use to which the appraisal report will be put.

Appraisers generally consider three approaches to value: the cost approach, the sales comparison approach, and the income capitalization approach. The applicability of these methods and the weight placed on the value determined under each method, will vary depending on a multitude of factors, including the purpose and use of the appraisal, the age of the property, the property's income history, and so forth.

The following is a brief discussion of the types of situations for which we frequently perform appraisals of restaurant real estate.

Purchase Price Determination and Allocations. These appraisals typically are requested by the buyer, but may be requested by the seller as a tool to assist in marketing the property. The buyer is interested in determining whether the restaurant is worth the asking price, and perhaps determining the upside potential of the restaurant's real estate and business value. A motivated seller may need the third-party opinion of value to attract potential buyers. Where a seller and buyer have agreed on purchase price, an appraisal may be used to allocate the purchase price between the various assets being purchased; both seller and buyer will be affected by the valuation conclusions. The allocations within the appraisal are likely to be the basis for allocations set forth in the purchase and sale documents, and then reflected on the seller's and buyer's books, and subsequently set forth on tax returns. These allocations will set the initial basis of the buyer's assets, and consequently affect the term and percentage used for depreciation and amortization purposes. The allocations will establish the amount of the sales proceeds of the items sold, and consequently will affect the seller's amount of taxable gain or loss, and depreciation recapture, if any. If a buyer or seller is audited, it is not uncommon for an audit of one party to lead to the audit of the other party. Where allocations are not set forth in purchase and sale documents, or are inconsistently reported by the parties, the Internal Revenue Service typically will take opposing positions with respect to each party, with the position taken for each party being that which results in the highest amount of taxes being paid. If a purchase is of a group of restaurants, it also is important to set forth in the appraisal report an allocation of the total purchase price to each restaurant being purchased, as well as then allocating the purchase price to the components being purchased (i.e., real estate, FF&E, and business). It can be of particular importance to set forth allocations among multiple restaurants, if one or more of the restaurants is located in a jurisdiction that imposes a transfer tax. It is far easier to justify an allocation where it is set forth in an appraisal than where the buyer's accounting department arbitrarily chooses numbers for their books. In addition, sales prices frequently are used by assessors as indicators of market value, and it can be difficult to argue retroactively that the sales price reflected on transfer documents was not really the subject property's market value at the time of sale.

Rent Negotiations. Some leases include provisions requiring periodic adjustments to a tenant's rent, with the new rent level to be at the then market rent. If the parties are unable to agree on what constitutes market rent, the lease may require the parties to obtain one or more appraisals to be used in the negotiating process. The lease may also specify the factors that can be considered by the appraiser. For example, rents of comparable properties, either on a square foot or location basis; or revenue generated by the tenant. Frequently, the appraiser may also serve as an arbitrator to the parties, to assist the parties in reaching an agreement.
Financing Transactions, Including Sale and Leaseback Transactions, and Refinancing. These appraisals typically are requested by the lender, and paid for by the restaurant owner. In performing these valuations, it is important to determine which assets the lender is willing to lend on. For example, some lenders will only lend on the real estate and FF&E, while others may be willing to lend on business value, as well. Where the real estate is leased, the lender typically will lend only on FF&E. Where the transaction is a sale/leaseback, the real estate interest value typically is based upon a capitalization of estimated rent. Rent is estimated as the greater

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of a predetermined percentage of revenues or a fixed percentage of the cost or acquiring or constructing the restaurant. The real estate interest value includes the land, building, and improvements used by the restaurant operator. Where the same entity operates the restaurant and owns the real estate, there may be an overlap between the value of the real estate value and the value of the business. As rental payments increase, all else remaining the same, restaurant cash flow decreases and real estate value increases, while business value decreases and total value increases. It should be noted that sale/leaseback transactions typically involve an “investment value” rather than “fair market value,” because the terms of the sale/leaseback are tailored to meet the requirements of a particular investor, and do not necessarily reflect the price that a “hypothetical willing buyer and willing seller” would agree to in an open market.

Feasibility of Proposed Restaurants. These appraisals typically are requested by either the developer of a property or the prospective lender, in order to determine whether the proposed project is likely to be successful, the cash flows likely to result from the project, and the associated risk level of a loan. These appraisals help determine the feasibility of construction or renovations. These appraisals evaluate market demand, identify the local competition, analyze the economics of the proposed property, set forth projections of income and expense, and lead to valuation conclusions under the cost, income, and market approaches.
Litigation. Where disputes involving restaurants end up in litigation, an appraiser may be engaged as an expert witness. The issues in dispute will determine many aspects of the appraisal report. Examples of litigation include lease disputes, divorce, and foreclosures. Under USPAP, an appraiser “must not perform as an advocate for any party or issue” because if an appraiser is an advocate, market value may not be reflected. Both sides to the dispute will scrutinize these appraisal reports. Frequently, the appraiser will be asked to testify regarding his valuation conclusions, in a deposition or at trial, or both.
Property Tax Challenges. A successful challenge of an assessor’s value may require an appraisal of the restaurant real estate. While an appraisal for ad valorem tax purposes will consider all three approaches to value, the income approach is likely to be the key approach, unless the property is very new, in which case the cost approach will increase in relevance. The sales comparison approach will be used as a check on the value reached under the income approach. An essential component of these appraisals is the isolation of the real estate component of the restaurant from the business value, and from the return on and return of personal property. The determination of the appropriate capitalization rate for the real estate is also important.
Gift and Estate Tax. These appraisals are used to support the value of the gift or bequest as stated on the tax returns filed in connection with the gift or bequest, by the donor or the decedent’s estate, respectively. The methodology for these appraisals is prescribed by the Internal Revenue Service in Revenue Ruling 59-60.

Other instances in which appraisals of restaurant real estate may be performed include condemnation proceedings, and settlement of insurance claims.

If you would like more information on HVS Food & Beverage Services, please contact Richard D. Williams at (303) 771-4104 or by e-mail at rwilliams@hvsinternational.com.

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