

Valuation Tips: How to Handle Real Estate/Rent Issues in Step 7

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Valuation Tips

How to Handle Real Estate/Rent Issues in Step 7

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Real Estate and Rent Adjustments (Step 7 and Steps 4/5)

I am asked from time to time to comment on a value estimate which is considered “off” by the user for unknown reasons. In many cases, the **key reason has been the treatment of rent expense** (and real estate assets/liabilities).

Properly following Step 7 (and possibly making an adjustment via Step 4 for Assets and Step 5 for liabilities) will **ensure that all correct entries and adjustments are made** in order to properly separate business value (ensuring a market level rent is recognized) from real property value and incorporate the real estate value (net of mortgage debts) into the final estimates of value (asset sale value, equity value and enterprise value).

Importantly, the **only time rent expense is annualized and deducted from SDE** is if the **subject business owns the real estate and is NOT recognizing any deduction for rent expense in the pretax income figure entered in Step 3.**

In most cases, the business does not own the real estate and is paying a market level rent negotiated at arm’s length with an independent landlord/lessor. In fewer cases, there will be real estate which shares common ownership with that of the business entity.

In general, the real estate is either owned by the business entity itself **OR** by a separate but related entity (real estate holding company). Following instructions for Step 7 will ensure that the proper sequence of adjustments are made to separate the real estate value from the business value and to include them both together for presentation purposes in the Bizequity Report.

- **If the business owns the real estate through a separate entity AND it is paying a market rent to that entity, no adjustment to the SDE will be made.**
- **If the business owns the real estate through a separate entity and it is NOT payment a market rent to that entity, the SDE will be automatically adjusted to account for market level rent based on user entries in Step 7.**
- **If the business owns the real estate through the business/operating entity being valued AND it is carried on the firm’s balance sheet, the same entries as noted above will accurately separate the business value from the real estate value. **HOWEVER**, it is first necessary to **REMOVE** the land and building assets (Step 4) and any mortgage debts (Step 5) from the firm’s balance sheet entries.**
- **If the business owns the real estate through the business/operating entity being valued BUT it is NOT listed or carried on the firm’s balance sheet, the**

entries in Step 7 for the annual market level rent, the fair market value of the real property and the current mortgage balance will accurately separate the business value from the real estate value.

Real Estate and Rent Expense Hints

Real estate and rent expense are treated differently depending on whether the owner is *paying and deducting rent expense* (either to an unrelated party/landlord or to a related entity also owned by the business owner) or not paying and deducting rent expense (because the same entity owns the business AND the underlying real estate, the business cannot pay rent to itself).

Is Rent Expense Recognized/Deducted Towards Reaching Pretax Income Figure in Step 3?

If rental payments are already being made and deducted to reach the pretax income entered during Step 3, no further adjustment to SDE is necessary UNLESS the payments are NOT reflective of a true market level rent burden.

Does the Pretax Income Figure in Step 3 not Reflect Rent Expense?

If NO rental payments were deducted to reach the pretax income figure on Step 3, the SDE will be adjusted downward by the amount of the annual rental payments at current market level as entered during Step 7.

Do You Want to Include the Real Estate Value in the Final Value Estimates?

Likewise, the real estate and related mortgage debts may be handled through the 7th and final step in the algorithm (the "own" versus "rent" question). The user must enter the current estimate of FMV for the real estate (excluding leasehold improvements) and the current mortgage balance related to the subject real estate as well as actual versus market level rent expense to fully execute Step 7. Remember also that if the real estate (land and building) is currently on the operating entity's balance sheet (as opposed to a second but related entity), you must subtract the book value of the land and building AND any mortgage balances/liabilities from the Steps 4/5 entries. This step has the effect of removing the book value of these assets/liabilities and replacing them with fair market values.

Is the Rent Expense Recognized in Step 3 Above or Below Current Market Level?

A final situation that can be handled via Step 7 involves either the payment of rent expense which is either "above market level" or "below market level". For example, the business may be paying \$120K per annum in rent expense to a related entity even though the current "market level rent" is approximately \$60K per annum, i.e. the business is paying a higher rent level than what a hypothetical buyer would pay and the SDE should be adjusted upward by the difference of \$60K (and vice-versa if actual rent is less than market level).

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