A Reprint from *Tierra Grande*

Valuing Business Intangibles

By Charles E. Gilliland

When Texans voted to exempt intangible personal property from ad valorem taxes, they were no doubt thinking of stocks, bonds and bank accounts.

That exemption has resulted in controversy and legal confrontations for some businesses as appraisers have begun to place a value on entrepreneurial expertise, innovation and strong leadership in successful business operations. Appraisers must now discern how much of a firm's operating success originates from its tangible assets, such as real property and personal property, and how much stems from intangible assets.

Determining a firm's value by capitalizing the entire income generated at a particular site captures both the contribution of the physical assets and the intangible influence of the unique business model that generated the income. The total of these two is the *going-concern value* and includes business enterprise value of both identifiable and nonidentifiable intangible assets.

Without a strong business model, a firm's tangible property could not achieve a superior profit. Determining the value of properties owned by large, complex businesses with multiple sites is particularly complicated as it requires differentiation between the physical and nonphysical assets contributing to value.

Business enterprise value expresses a judgment of the worth of the business model of an operating firm. That judgment includes the benefits from current and foreseen employment of the assets bound up in that business. Because the organization's revenue stream is produced from operation of the model, an appraisal focused on income-generating capacity ensures that the resulting valuation includes both tangible and intangible asset values. In essence, such an analysis renders an evaluation of the organization — the physical assets, identifiable intangible assets and the business model — and not the value of its physical and identifiable intangible assets on the open market.

Business Model Contributes to Value

When the business model that creates the business enterprise value becomes the focus of an appraisal analysis, the results provide a measure of the tangible assets' unique worth to a particular configuration only, known as *value-in-use*. Only when a large number of competitors with similar competing business models vie for the same set of tangible assets — buildings, equipment and machinery, for example — does the business enterprise value converge to a *value-in-exchange* that corresponds to market value in appraisal.

When that level of competition is present, an appraiser can safely argue that the so-called intangible elements of the business have enhanced the value of the tangible items and, therefore, have become part of the tangible asset value. In these circumstances appraisers should find sufficient numbers of arms-length transactions to avoid total reliance on the income approach to value.

Consider the case of a firm operating two chains of oil terminals — one stretching from the Gulf Coast to Memphis and the other from Ohio to the Atlantic. Suppose the firm acquires a number of take-or-pay contracts along with its acquisitions in assembling these chains. The firm then buys three terminals linking the Atlantic chain with the Gulf coast chain. This enables it to move oil from the Gulf coast into the international market in New York, reducing costs and increasing profit.

Prices paid for the three terminals exceeded established market norms. Why? Because those terminals completed a structure envisioned by the business model and gave the firm a stronger position in the petroleum market. The firm paid more than market value to acquire the last pieces of their network. The excessive price reflects the value of those last terminals to that particular business enterprise, not their value on the open market.

If a superior business plan produces an enlarged income stream and creates value above costs, an inferior plan does the opposite. A deficient business plan can cause the value of the organization to fall short of the aggregate value of its assets on the open market. In these cases, gains follow from dissolution of the business and subsequent sale of the assets to more efficient producers. The wave of takeovers in the 1980s that saw corporate raiders plunder vulnerable companies signaled a paucity of business enterprise value in the targeted firms.

Challenge of Estimating Enterprise Value

Companies spend significant energy every year debating tax appraisers over the value of real estate and tangible personal property owned. The Appraisal Standards Board developed Standard 9 of the Uniform Standards of Professional Appraisal Practice (USPAP) to address assignments involving business enterprise value. At the same time, practitioners struggled to develop a methodology for producing credible estimates.

Because there is no ultimate market test of estimated business enterprise value, appraisals of intangible elements of operating businesses remain fraught with controversy. Market developments can erase business enterprise value, and, therefore, many question its presence for specific firms. Questions remain regarding both the existence of identifiable intangibles and acceptable methods of appraising them.

Toward an Appraisal Theory

In the January 2002 issue of *The Appraisal Journal*, Wolverton et al. offer a lexicon (see "Appraisal Lexicon") designed to guide appraisal applications in segregating the value of intangibles from tangible assets. The model to establish the separate value of each business component requires estimating the following (real property value is determined as a residual in this model):

value of total assets of the business
– furnishings, fixtures and equipment value (FF&E)
– cash and equivalents value
– skilled workforce value
– name, reputation, affiliation value
– residual intangible assets value
= real property value as a residual

Economic profit consists of the excess of revenues above opportunity costs of inputs used to produce those revenues. Economic profit continues each year as long as a firm has this economic advantage over potential competitors. When others replicate the production process, the advantage disappears as output prices drop and input costs rise.

Because of the ephemeral nature of business, economic profit unavoidably expands or contracts. Capitalized economic profit is the discounted present value of a firm's economic advantage. Therefore, capitalized economic profit (CEP) may exist at one date only to vanish as market conditions create new realities that extinguish economic advantage. The fleeting character of economic profit makes it the most contentious component of business enterprise valuations.

Appraisal Lexicon

Going concern — an established and operating business having an indefinite future life.*

The going concern concept recognizes the contribution of the business and the systems developed to implement it. It acknowledges the transitory nature of the advantages garnered by that business by specifying an indefinite future period of operation.

Market value of the total assets of the business — value of all tangible and intangible assets of a business as if sold in aggregate as a going concern.*

This concept embodies an estimate of the value of the temporary advantage accruing to the business because it possesses a unique set of assets organized by a superior business model.

Total intangible assets — all of the intangible assets owned by a business (going concern).*

These assets represent the value the business model creates beyond the market value of the assembled tangible assets.

Identified intangible assets — Those intangible assets of a business (going concern) that have been separately identified and valued in an appraisal.*

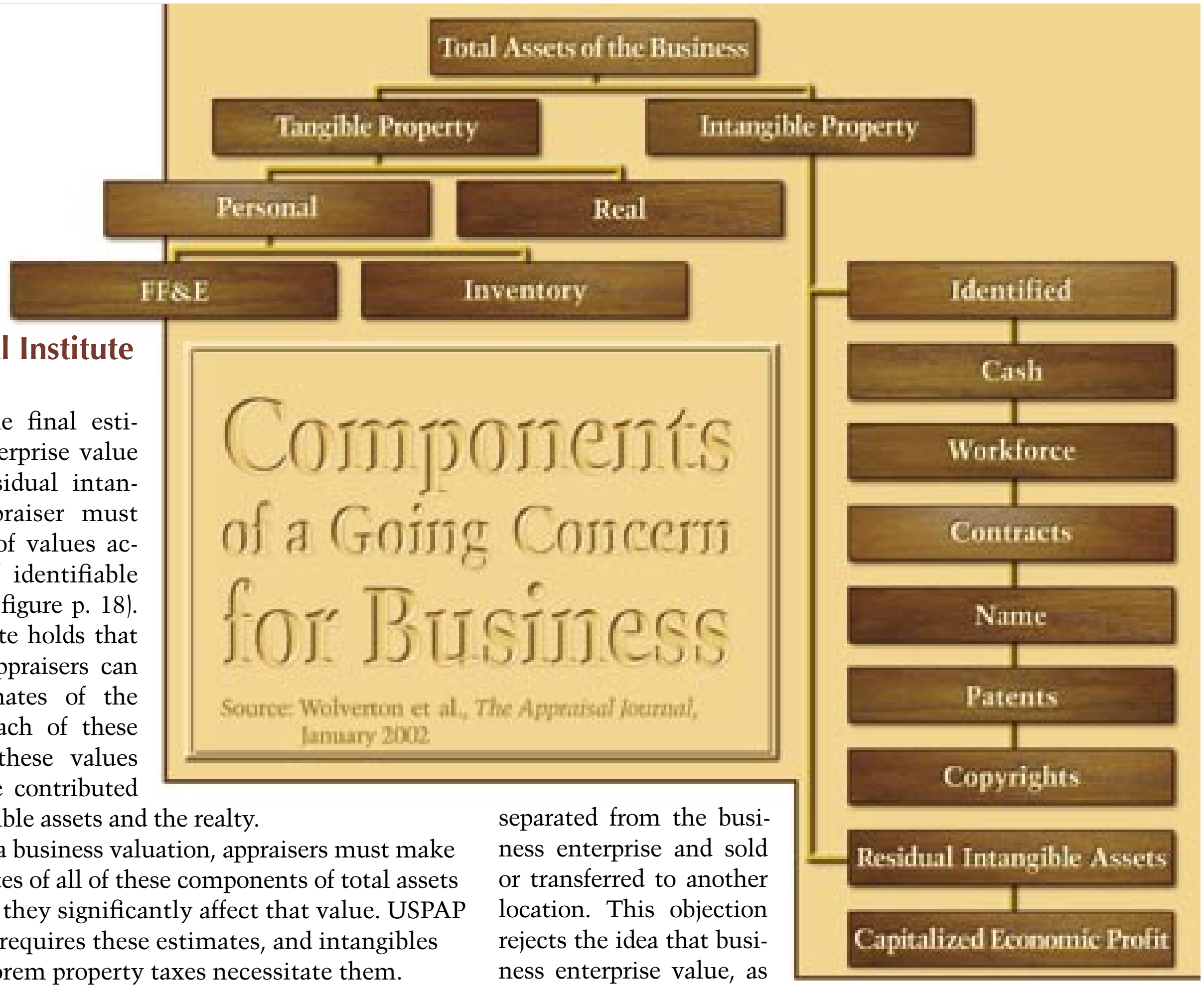
These assets represent advantages enjoyed by the firm with respect to potential competitors. An assembled, skilled workforce that enables a business to respond more quickly and expertly in the product market than its potential competitors is an example of this kind of asset.

Residual intangible assets — those intangible assets of a business (going concern) that have not been separately identified and valued in an appraisal. The value of residual intangible assets equals the value of total intangible assets minus the value of identified intangible assets.*

This residual represents the value of the contribution of the business plan after compensating for all other assets including identifiable intangible assets. This residual exists because the business has gained an advantage over potential competitors that allows the business to retain the economic profit. In accounting, these influences are frequently labeled goodwill.

Capitalized economic profit — the present worth of an entrepreneur's economic (pure) profit expectation from being engaged in the activity of acquiring an asset, or collection of assets, at a known price and then selling, or being able to sell, the same asset or collection of assets at a future uncertain price.*

*Source: Wolverton et al., *The Appraisal Journal,* Jan. 2002



Components of a Going Concern for Business

Source: Wolverton et al., *The Appraisal Journal*, January 2002

Current Appraisal Institute Thinking

Before reaching the final estimate of business enterprise value embodied in the residual intangible assets, an appraiser must deal with the issue of values accruing to the list of identifiable intangible assets (see figure p. 18). The Appraisal Institute holds that despite difficulties, appraisers can devise reliable estimates of the exchange value of each of these items. Removal of these values leaves only the value contributed by the residual intangible assets and the realty.

When determining a business valuation, appraisers must make separate value estimates of all of these components of total assets of the business when they significantly affect that value. USPAP Standards Rule 1-4(g) requires these estimates, and intangibles exemptions in ad valorem property taxes necessitate them.

To derive the realty component, appraisers must fall back on the traditional three approaches to value: the cost approach, the sales comparison approach and the income approach.

Continuing Controversy

Notwithstanding the Appraisal Institute's pronouncements, appraisers continue to argue against the existence of separable intangible values. They particularly criticize the idea of residual intangible value.

Noting the influence of intangible elements on residential property — superior views and neighborhood cachet, for example — some argue that the intangible elements enhance the values of the tangible commercial assets. The residual intangible value that one appraiser sees appears to another as a locational premium accruing to the real estate. One appraiser may estimate a substantial business enterprise value addition to a specific hotel building because it is affiliated with a nationally prominent chain. Another may argue that the hotel's location creates its highly profitable revenue stream.

Recall the source of intangible value: that increment to income that exists because of the superior aspects of the business model guiding property management. The brains behind the operation count for more than the bricks and mortar. If competition from competing enterprises emerges in sufficient quantities that the surplus above cost has vanished in a cost squeeze, the intangible value has vanished. To sustain the residual intangible value, the operator must continue to enjoy advantages that competitors cannot duplicate.

Opponents of the CEP concept frequently assert that the residual intangible value cannot exist as property until it can be separated from the business enterprise and sold or transferred to another location. This objection rejects the idea that business enterprise value, as an increment accruing to superior business acumen, can ever be demonstrated to exist.

The key to achieving a business value as an economic surplus remains the ability to operate in an atmosphere of limited competition. Competition inexorably erodes economic profit. Barriers to entry, specialized knowledge or processes and all other features of a product market that conspire to limit competition create and sustain economic profit.

The crucial element of a business model that confers residual intangible value is its ability to produce superior results that others cannot copy. If a business enterprise can credibly demonstrate that it enjoys such an advantage, business enterprise value must exist.

Although the Appraisal Institute has begun to weigh in on the topic of intangibles in appraisals, the matter is far from settled. The controversy is increasingly ending in courtroom confrontations. Judging from industry reports, courts remain confused about the sources and nature of business enterprise value. Careful analysis and documentation of value estimates may fail to persuade unless combined with a lucid defense of the methods and data used.

In the end, those who present the most compelling explanation of business enterprise value likely will carry the day. From an economist's viewpoint, the winning argument should explain why the enterprise enjoys or does not enjoy a unique advantage and how long that advantage will persist.

Dr. Gilliland (c-gilliland@tamu.edu) is a research economist with the Real Estate Center at Texas A&M University.

MAYS BUSINESS SCHOOL

Texas A&M University
2115 TAMU
College Station, TX 77843-2115

http://recenter.tamu.edu
979-845-2031
800-244-2144 orders only

Tierra Grande (ISSN 1070-0234), formerly *Real Estate Center Journal*, is published quarterly by the Real Estate Center at Texas A&M University, College Station, Texas 77843-2115. Subscriptions are free to Texas real estate licensees. Other subscribers, $20 per year.