Convenience Stores and TRPs in Condemnation: Special Valuation Issues in the Application of the Income Approach

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The property owner was chagrined when he opened the appraisal report completed by the State Department of Transportation. The appraisal did not include any mention of the annual sales or earnings from the property.

Yet, this convenience store and fueling site were being condemned as part of a freeway widening project, and the State is required to pay the owner fair market value for the real estate. There are no other fueling facilities within 10 miles, and because of the close proximity of nearby industrial firms with heavy truck traffic, the subject site sells about five times as many gallons of diesel fuel annually as a typical location. The owner believes the price offered by the State for his property is too low and insists that a competent appraisal must consider the above-average earnings.

Several condemning agencies across the country are moving to exclude any earnings-based valuation analysis in real estate appraisals. If successful, this movement will eliminate one of the most useful and direct measures of fair market value for special-purpose income properties, such as convenience stores, fast-food restaurants, car washes, and motels and hotels. Consequently, the value of high-performance locations for these types of properties is likely to be under-appraised, resulting in inadequate compensation to the property owner.

The valuation principles discussed in this article will assist appraisers and eminent domain attorneys in the appraisal of a wide variety of income-producing properties, not only convenience stores. This article will provide a better understanding of when earnings-based valuation procedures are needed in condemnation and other types of litigation. It will also discuss the appraisal industry's best practices for appraising convenience retail and other special-built, income-producing real estate. This article identifies some misunderstandings in current court decisions and offers advice for appraisers and attorneys involved in property litigation cases using earnings-based valuation procedures.

The Movement to Eliminate Earnings-Based Valuation

The argument being made by the condemning agencies is that any earnings-based valuation procedure inherently includes business value. In states where business value is not compensable, they contend that any measure of value using earnings is irrelevant and should be excluded. In 2013, this argument was brought by the Kansas Department of Transportation in a motion in limine to exclude an earnings-based income approach as evidence of value in a condemnation case involving a gas station. Order, Def. Mot. In Limine, *Presta Oil, Inc. v. Michael S. King, Sec'y of Transp. for the State of Kan.*, No. 09CV 226 (D. Ct. Finney Cnty., Kan. Sept. 4, 2013). The Kansas court ruling excluded any valuation evidence that considers earnings.

Although earnings may be considered in the adjustment to sales, any earnings-based valuation procedure is inadmissible in Nebraska. In contrast, New York courts allow an earnings allocation method even though lost business profits generally are not compensable in New York. Currently, arguments are being heard in the Texas Supreme Court on excluding earnings-based appraisal procedures in a condemnation case.

As will be shown below, however, earnings-based capitalization methods are crucial to accurate estimation of market value of real estate for trade-related income properties, and these techniques should be included as part of an appraiser's valuation analysis and considered by the courts.

Trade-Related Real EstateIs Different from OtherTypes of Property

The valuation of convenience stores, gas stations, car washes, and hotels and motels are not the usual or typical appraisal. Too often, appraisers and the courts attempt to use the same techniques and methods as for multi-tenant and generic commercial real estate, such as comparable rental analysis, conventional sales comparison, and cost approaches. This will not work.

These highly specialized properties are built, bought, and sold for a narrow and specific economic use, the location and design of improvements are determined by that use, and the real estate is not easily adaptable to other functions. With these types of properties, the value of the real estate is recognized as being directly proportional to its earning capacity for the intended use. For a typical convenience store business enterprise, the largest component of value is the real property, the land and improvements, constituting up to 90% of the value of the total assets of the business. As will be shown, the value of the real estate for these properties is best estimated using an earnings-based income approach.

International Valuation Standards (IVS) recognizes the unique appraisal issues presented by what is termed trade-related property (TRP). A separate valuation standard, Standard 232, deals specifically with TRPs. IVS defines a TRP as

> any type of real property designed for a specific type of business where the property value reflects the trading potential [earnings capacity] for that business. Examples include hotels, fuel stations, restaurants, casinos, cinemas and theatres. The essential characteristic of this type of property is that it is designed, or adapted, for a specific use and the resulting lack of flexibility means that the value of the property interest is normally intrinsically linked to the returns that an owner can generate from that use. The value therefore reflects the trading potential of the property. It can be contrasted with generic property that can be occupied by a wide range of different business types, such as standard office, industrial or retail property.

Using a convenience store as an illustration, where does net operating income to real estate originate? In other words, how does the store owner get the money to pay for the mortgage and equity requirements of the real estate? The answer is that net operating income (NOI) to real estate is taken from the cash drawer, just as is the money to fund everything else. So it makes sense that someone would pay more for the assets of a store that earns a lot, day in and day out, year after year, than for one that consistently cannot pay its bills. Because the real estate is a part of that collection of assets, a typical buyer would pay more for the real estate of a higher-earning store. That observation provides essential insight into the valuation logic for TRPs.

Weakness of the Sales Comparison and Cost Approaches

Both the sales comparison and cost approaches are indirect measures of value for income-producing real estate, and appraisers seldom use these approaches as dependable indicators of value for income property. Neither approach considers the ability of the earnings or income of the property to satisfy the investment requirements of the real estate. For example, the real estate of a convenience store appraised using the sales comparison approach could be valued at $1 million, while the earnings under typical management might only support a real estate investment of $750,000. In this instance, if an operator were to purchase the property for $1 million, it could find itself unable to pay for the property. This discrepancy can arise because the sales comparison approach considers the sale prices of stores at other locations only. Using this approach, the appraiser makes no examination of the subject's earnings or economic performance, or whether the store will actually earn enough to pay for the real estate. Likewise, the cost approach does not consider income or earnings. Unless special care is taken by the appraiser, the sales comparison and cost approaches almost always under-value convenience stores in high-performance locations.

The cost approach is hypothetical. It assumes a new store is constructed, when in fact the subject may be an existing store that has operated for many years. No earnings analysis is performed. The cost approach has severe limitations in reflecting the trade area characteristics that cause a convenience store's earnings to be high or low. For this reason, the cost approach tends to under-value high performing stores and over-value low performing stores. The cost approach is a weak measure of value for an income-producing property, such as a convenience store or other TRP.

Improving the Sales Comparison and Cost Approaches

The location adjustment in the sales comparison approach should reflect all of the related characteristics that affect value for the particular TRP. This can vary from one category of TRP to another, and a single adjustment can rarely account for all location-related factors. With TRPs, it is often necessary for an appraiser to expand the location adjustment from a single-line item to consideration of additional factors. With complex location issues, especially those of convenience retail real estate, essential trade area and site characteristics must be part of the adjustment process for a credible sales comparison approach.

The convenience store appraiser should at least consider the following, through separate line-item adjustments or analysis: the supply and demand characteristics of the subject trade area and all of the comparable sales; resident customer demographics in the trade area of the subject and all of the comparable properties; and any hypermarket competition for the subject and all of the comparables. Statistical studies have shown that for TRPs, these three location factors can increase or lower the value of the real estate by 30% to 35%.

When the cost approach is applied to convenience retail real estate, the appraiser should assure that the estimate of replacement cost is supported by actual cost comparables of other convenience stores that have been built recently. Some cost services, such as the Marshall Valuation Service, tend to understate the construction cost of convenience stores. If a cost service is all that is used, the appraised value is often lowered by this approach. In using the cost approach, it is important to select site sale comparison properties that have a highest and best use for convenience retail. All other things being equal, because of the requirements of superior access and visibility, convenience retail sites tend to sell higher than those for destination retail or some lower-order commercial uses, such as restaurants and offices. Note that the cost approach cannot be used to estimate intangible asset value.

For these reasons, in valuing the real estate of TRPs, the IVS flatly states: "The cost approach is not normally appropriate" and "[t]he direct market comparison [sales comparison] approach is often a less reliable indicator of value than the income approach."

In addition, IVS goes on to state that the value of the real estate of TRPs "reflects the trading *potential* [earnings capacity under typical ownership], rather than the actual level of trade under the existing ownership." Because of this, TRP real estate is best valued with earnings-based income methods, which are discussed in the balance of this article.

The Capitalized Income Approach for Convenience Stores and TRPs

Two methods are available for processing the capitalized income approach for convenience stores and most other TRPs. One is the comparable rental analysis. A comparable rental analysis is best for properties built for their rental income, such as apartments, offices, and multi-tenant retail malls. The other method is any earnings-based capitalization procedure. IVS states that earnings-based procedures are best for TRPs, such as convenience stores, car washes, motels, and gas stations, which are an integrated part of a business enterprise.

In a comparable rental analysis, the appraiser essentially has two steps. The market rent to the real estate is estimated from comparable rental properties. It is the appraiser's task to go into the marketplace and find leased properties similar to the subject. A comparison analysis is often prepared, much like the adjustment grid used in the sales comparison approach, to estimate the market rent for the subject store. Once the market rent has been estimated, a multiplier or capitalization rate is used to capitalize the market rent into a value estimate. A comparable rental analysis is best suited to commercial properties built to produce rental income, such as multi-tenant retail, apartments, and mini-storages.

TRPs are not built for rental income. There are significant problems with a comparable rental analysis for TRPs. First, in applying a rental capitalization, good rental comparable properties, which are required for the procedure, are often difficult to locate because TRPs are not usually rented. Sale-leasebacks are not rental comparables and have been rejected by the courts. Second, the location adjustment is difficult for the same reasons as the sales comparison approach. Making a proper estimate of market rent requires location considerations similar to those described above for the sales comparison approach. That is, the appraiser must identify all trade area and location characteristics for the subject store as well as each of the comparable rentals.

Convenience stores are built to sell gasoline, merchandise, and food service and to make a profit. The real estate is part of the assets brought together by the operator to do this. Earnings-based valuation procedures best reflect this market reality.

Earnings-BasedEstimates of Value

Of the available approaches, earnings-based procedures most closely emulate the actions of actual buyers and sellers for TRPs and are the preferred method of valuation. Buyers of convenience stores judge the value of the real estate according to the earnings potential for the location, and these methods best replicate the market in establishing real estate pricing. In other words, the value of the real estate will rise or fall depending on whether the location produces high or low sales revenue and volume.

The Appraisal Institute's primary textbook on the valuation of convenience stores recommends an earnings-based income approach: "The methodology of the earnings capitalization parallels the way industry participants view real estate. The real estate, like all other assets, is considered in its context of its contribution to earnings" and, "[b]ecause it is a component part of these assets, the value of the real estate is dependent on earnings capacity. This is the fundamental premise of value for a convenience store." Robert E. Bainbridge, *Convenience Stores and Retail Fuel Properties: Essential Appraisal Issues* (2d ed. 2012).

Notice that these quotes deal with the value of the real estate. A misconception exists that any earnings procedure must include equipment and intangible assets in the value estimate because they contribute to gross earnings of the business enterprise. This is not true. The illustrations below describe how real estate income and value can be separated.

For convenience stores and TRPs, several earnings-based valuation procedures are available to the appraiser. For appraisers specializing in convenience stores, gas stations, and travel centers, using economic or performance-based valuation procedures in their analyses is common. None of these earnings or performance-based valuation procedures is restricted to appraising or inclusion of business or intangible asset value. They can all be used to estimate the value of the real estate. In fact, these earnings-based procedures are usually better at estimating the value of the real estate for these types of properties and are often used when separate real estate values are required, such as mortgage lending appraisals. These performance-based valuation procedures include a gross profit multiplier, a price-per-gallon multiplier, an in-store sales multiplier, and an EBITDA allocation procedure.

The EBITDA Allocation Procedure

Earnings before interest, taxes, depreciation, and amortization (EBITDA) is a common measure of earnings in the retail industry, which is simply gross profit less business operating expenses. All business enterprises have three broad classifications of assets: tangible assets, real property, such as the site, and buildings; tangible assets, nonrealty, such as shelving, cash registers, and other moveable personal property; and intangible assets, or business value, sometimes called “blue sky.” The typical allocation of adjusted EBITDA for a convenience store in the United States is shown below:

Percentage of Adjusted EBITDA

Tangible Assets, realty (site, store building, fuel service): 70%

Tangible Assets, nonrealty (movable FF&E): 10%

Intangible Assets (accounting profit): 20%

Clearly, most of the store’s earnings originate from real estate-related factors. When these allocations are capitalized, the typical percentage breakdown of the asset values are:

Percentage of Market Value of the Business Enterprise

Tangible Assets, realty (site, store building, fuel service): 90%

Tangible Assets, nonrealty (movable FF&E): 3% to 4%

Intangible Assets (accounting profit): 6% to 7%

Seven steps are included in the EBITDA capitalization procedure, as shown in the box.

The penultimate step is to allocate adjusted EBITDA, which is the gross return to the assets of the business. Once the allocation is made, these earnings can be capitalized to the value estimates for the three asset classifications. The EBITDA allocation procedure can be used to estimate the value of all three asset classes: real estate; fixtures, furniture, and equipment (FF&E); and intangible assets.

When the earnings allocation to real estate has been made, as illustrated in the box, this portion of earnings represents the economic rent of the real estate. Unlike the sales comparison and cost approaches, this is a direct analysis of the ability of potential earnings to financially support the estimated value of the real estate.

Some of the advantages of the earnings-based procedure include the following:

1. Of all the valuation procedures, it most nearly reflects how buyers and sellers view the value of the real estate. Real estate is not merely a physical asset but an economic asset whose value is determined by its earnings capacity.
2. The EBITDA allocation procedure allows for the estimation of individual values of all three asset classes with less likelihood for error than other valuation approaches. It is the only practical technique that allows a direct estimate of intangible asset value.

3. Abundant published industry benchmarking data makes processing this procedure much easier and more accurate for convenience stores and gas stations.
4. An earnings-based approach is less prone to over-value poor locations or under-value good locations.
5. Earnings-based procedures are consistent with IVS Standard 232.

Current Misconceptions, Misunderstandings, and Mistakes in Arguments Against Earnings-Based Valuation Approaches

The appraiser in *Presta* incorrectly capitalized all of EBITDA. This was a mistake. The appraiser should have allocated EBITDA to the three classes of assets. The court was correct to exclude this earnings analysis as evidence of market value. The Kansas ruling, however, used imprecise terminology, unsubstantiated reasoning, and a lack of knowledge in excluding an EBITDA allocation procedure as evidence of fair market value of the real estate.

Following are some of the important shortcomings of the ruling.

Mistake 1: "EBITDA is business profit."

The court is mistaken in equating earnings with business profit. In the court's logic, because lost business profit is not compensable, any evidence of earnings must be excluded. EBITDA is the gross economic return of all assets, including the real estate. When EBITDA is properly allocated, an accurate measure of real estate value may be obtained.

Mistake 2: "Earnings [such as motor fuel gallonage, merchandise sales, gross profit, and EBITDA] are inherently a measure of the business acumen, skills, and knowledge of the operator."

Earnings in perfectly competitive markets have little to do with the management skills of the business operator. Incompetent management is quickly weeded out and innovative and successful management is copied and rapidly adopted by competitors, thereby reducing or eliminating any competitive advantage due to quality of management. The court should recognize that most of the earnings for many of these businesses are derived from the quality of the real estate, especially the location, not from the management of the business or the skills of the operator. The intangible, or business, component is often less than 10% of the total assets of the business enterprise, with tangible assets accounting for more than 90% of market value.

Mistake 3: "Location alone does not create revenue."

In reality, studies have shown that 40% or more of convenience store earnings are attributable to supply and demand in the trade area, resident customer demographics, traffic volume, access, visibility, and the level of hypermarket competition. These are all location-related characteristics. Quite to the contrary, location does create revenue for TRPs and, consequently, property value.

Advice for Attorneys

An earnings-based procedure is almost always crucial to an accurate estimate of market value for convenience stores and TRPs. In one particular pending condemnation case involving a well-located travel center in Texas, the inclusion of an EBITDA allocation method in the property owner's appraisal results in a damage award of several million dollars more than it would be otherwise. Attorneys can provide significant benefit to a client by paying attention to several details in the condemnation of a TRP. First, select an appraiser who is knowledgeable about the type of property and earnings-based appraisal procedures. The appraiser in the *Presta* decision was uninformed in the EBITDA valuation method used in the appraisal. As a consequence, important evidence in estimating value was excluded by the court. If an earnings-based procedure is challenged, the attorney should determine that any cited court decisions are based on correct valuation procedure. This requires a detailed understanding of the other appraiser's method and what the court actually reviewed. The *Presta* decision was based on a faulty appraisal. Review the appraisal report in these cases to determine whether the court was considering the same issues and measures of earnings, no matter how it was labeled by the court. Reviewing a case summary is often not adequate.

Second, if an EBITDA allocation is used as part of the valuation evidence in a condemnation appraisal, appraisers should describe the earnings allocation to real estate as "economic rent" and make clear that only the estimated real estate rent is capitalized. This helps the court both to understand the result of the allocation and to prevent it from wrongly assuming that noncompensable business value is included. The courts have long understood and accepted a capitalization of property rent. This was stated in the *Presta* case. It was evident, however, that the Kansas court did not understand that EBITDA can be allocated to an estimate of real estate rent and that this allocation is conceptually equivalent to using comparable rental comparisons in a generic income capitalization. When appraisers and attorneys provide simple, meaningful labels, such as "economic rent," this can help avoid confusion and assist the courts to better understand and more readily accept the EBITDA allocation procedure.

Third, the concept of an EBITDA allocation can be difficult for a judge or jury to easily grasp, especially if the opposing side desires to sow confusion into the issue. If an EBITDA allocation method is used in the valuation of convenience stores, gas stations, or travel centers, appraisers may wish to augment with one or more of the other earnings-based valuation procedures, such as the gross profit multiplier, gallonage multiplier, or in-store sales multiplier. These other performance-based procedures are simple to understand and can reinforce the conclusion of a complex EBITDA allocation method.

Finally, the court in the *Presta* case did not recognize that any earnings-based valuation procedure should be a capitalization of earnings under "typical management" and not a capitalization of the current operator's earnings. Earnings under typical management is the appraiser's projection of the level of economic performance by a typical operator. This is market earnings; and this is the critical bridge to an estimate of fair market value. Capitalization of the current operator's earnings is not fair market value. It is simply an expression of investment value or the value to that particular operator. The concept is similar to the valuation of any other income-producing property, such as an apartment or office building. The appraiser must make an estimate, or projection, of market income.

Summary

Convenience stores and trade-related property pose special valuation issues. Appraising these properties requires that appraisers often must go beyond the usual and customary appraisal methods used for other, less complex types of real estate. Convenience stores and TRPs have unique trade area and location considerations that significantly influence value and must be considered by the appraiser.

The three traditional value approaches are not equally useful in the appraisal of convenience stores and TRPs. An earnings-based analysis is the preferred method of appraising the real estate of these types of properties. Earnings-based procedures do not favor the property owner or the condemning agency, nor do they arbitrarily produce high or low value estimates for the real estate. Rather, these are accurate procedures with less likelihood for error that recognize a market reality: that the value of the real estate for TRPs is established by earnings capacity. Several earnings-based procedures that do not require any separation of nonrealty earnings are available to appraisers.

The attorney's role includes assisting the courts in a proper understanding of earnings-based appraisal methods. Otherwise, precedent may be established by legal challenges across the country today that, in future cases, eliminate an important and useful valuation tool. n