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Convenience stores, specifically those with fuel service, are ubiquitous across transportation right of way projects. Ironically, they are some of the most challenging property types to appraise in eminent domain proceedings. The following article is part one of two installments, which will spell out the challenges for appraisers valuing this property type for right of way. It is not meant to be comprehensive; rather, it aims to give appraisers and consultants a basic understanding of the specific issues faced when valuing convenience stores.

Define the Problem

Two significant issues stem from appraising convenience stores for right of way projects. First, convenience stores are a specialized property type which are often appraised incorrectly. Second, many states preclude any loss of business value from compensation, but right of way projects sometimes impact the business. This directly impacts the real property value, which makes determining appropriate damages difficult.

CONVENIENCE STORES

Part One: An inconvenient appraisal problem

We answer questions about convenience store appraisals all the time, so we have listed a number of typical questions we get about appraising convenience stores for right of way.

Right of way aside, why are convenience stores so difficult to value?

The short answer is convenience stores fall in the category of "going concern" appraisals in which the real estate plays a critical role in a business operation. Other than convenience stories, common examples include hotels, bed and breakfasts, funeral homes, wedding venues, breweries and even dragstrips! (Yes, we have appraised a dragstrip and no, we did not get to race—though we did ask.) Thus, convenience stores are not unique for being a property type for which the appraiser must value the going concern, and it is commonly affected by right of way projects. It is the rare (DOT/right of way) project that will affect a dragstrip.

What makes a convenience store a going concern is that typically convenience stores are purchased for the income that the business can generate, not for the rental income they can generate. In fact, even rental rates for leased stores are based on the expected profit. Moreover, the improvements are so specific—requiring underground storage tanks (USTs), large fixtures such as canopies, dispensers and signage—it is often not financially feasible to adapt the store to an alternate use. It is also worth noting some DOTs consider UST and other convenience store fixtures personal property.

In order to value a convenience store (as a going concern), the appraiser must be able to understand and value the components of the going concern. The going concern includes three components of value: the real estate, the FF&E (furniture, fixtures and equipment) and the intangible value. The appraiser must also be able to understand the factors motivating sellers and buyers in the market, which necessitates both an understanding of the pertinent factors driving a transaction and access to relevant data to provide a credible value conclusion.

Why is it important to value the going concern?

USPAP (SF 1-2(e) and 1-4 1-4(g)) requires appraisers to "identify and consider the effect on value of any personal property, trade fixtures, or intangible items that are not real property but are included in the appraisal."

Additionally, the definition of market value describes buyers and sellers as typically motivated, well-informed and acting in what they consider their own best interest. This definition implies appraisers must know who the willing buyer is and what motivates said buyer. If the buyer is motivated by the income potential of the business operation, the appraiser should attempt to value the property in a manner consistent with the expectations of buyers and sellers. Thus, if buyers derive their transaction prices on a gross profit multiplier and not per square foot, then it is the appraiser's job to mirror the market. Failing to reflect the actions and motivations of buyers and sellers in the market leads to reports that do not reflect market value because, in short, they do not reflect the market.

What happens when we ignore the going concern?

Ironically, if you use the sales comparison or income approaches, the going concern is included, but it is not identified. For example, let's say an appraiser finds three local convenience store sales and values his subject strictly on a price per square foot. The range is tight, and the appraiser feels like the value is spot on. Perhaps it is. Perhaps not. But our hypothetical appraiser simply comes up with a price per square foot and concludes the value. There is not allocation of the going concern to the components of value. However, the three sales may or may not include the USTs, the canopy, the reach-in coolers, POS system and so forth. The sales may or may not have been turn-key sales in which the new owner walks in the next day and takes over the business, meaning some amount of intangible/business value may be present.

When we reviewed several reports for Virginia DOT, we found this exact case. The property owners had three different appraisals of their store. One of the reports identified and valued the equipment; the other two ignored it, opting instead to value the convenience store on the per square foot and per unit methods and reporting a single figure with no allocation. None of the reports identified or discussed the presence of any intangible value in either the subject or the comparable. Because the appraisers had not allocated the components included in the going concern, the appraisals did not comply with USPAP.

So how does this work?

This is the truncated version, but when we get a new convenience store assignment, the first step is to request the production figures. This includes gallonage, inside sales, lottery and other miscellaneous income, as well as profit and expenses. Even on right of way projects, owners regularly share this with us (there is a whole method of estimating the production figures when the information simply is not available using production comparables; however, that is a whole other article). This information can also be subpoenaed. From the subject data and market information, we derive a projection of the subject's gross revenue, gross profit and earnings before interest taxes depreciation and amortization (EBITDA). From the gross profit and EDITDA, we can use comparable data and reach a going concern value via the sales comparison and income approaches. Concurrently, we develop a cost approach. The cost approach includes real estate and FF&E, but not any intangible value. Now we have three values, two of which include all three components of value (the real estate, the FF&E and the intangible value).

Finally, we allocate the values to their components and any excess EBITDA not tied to the investment in the real estate and FF&E is allocated to the intangible value.

Thus, the report includes four values: the going concern value (the value of the entire operation) and the three components of value (real estate, FF&E and intangible value), which total the going concern. This allocation is critical for several reasons. For instance, a lender does not want to loan on intangible value and many states do not compensate for lost business value (if they do, it is only under very narrow guidelines). Moreover, many states are very specific about what FF&E they will buy from property owners, so without a proper allocation, appraisers may very well be including items in the compensation that are non-compensable.

Why not only develop the cost approach and avoid all the going concern issues?

That is a fair question since the cost approach is clean in this regard, clearly reporting the land value, value of improvements and the value of the FF&E. Our reasons for not solely developing the cost approach are:

1. Buyers give the cost approach the least possible consideration, so it does not reflect the actions or attitudes of market participants. Remember the definition of market value?

2. Without a second or third approach, the cost approach can be a wide target, lessening the credibility of the report. Given the compensation amounts and the litigious nature of these assignments, our clients do not accept cost approach-only reports.

3. When using the cost approach for appraising convenience stores, we regularly see a discrepancy in the cost comparables we have and M&S. If the appraiser does not have cost data from actual newly built stores, it is one more reason to develop the other approaches.

4. It is not feasible to address many impacts from right of way projects without income data or at least an understanding of the relationship between the income a store generates and its real property value.

What's the deal with the gross profit multiplier and EBITDA?

The gross profit multiplier is a unit of measurement derived from comparable sales. Think of the gross profit multiplier like a price per acre for land. It is derived by dividing the sales price by the sale's gross profit. The EBITDA can be capitalized to reach a value conclusion.

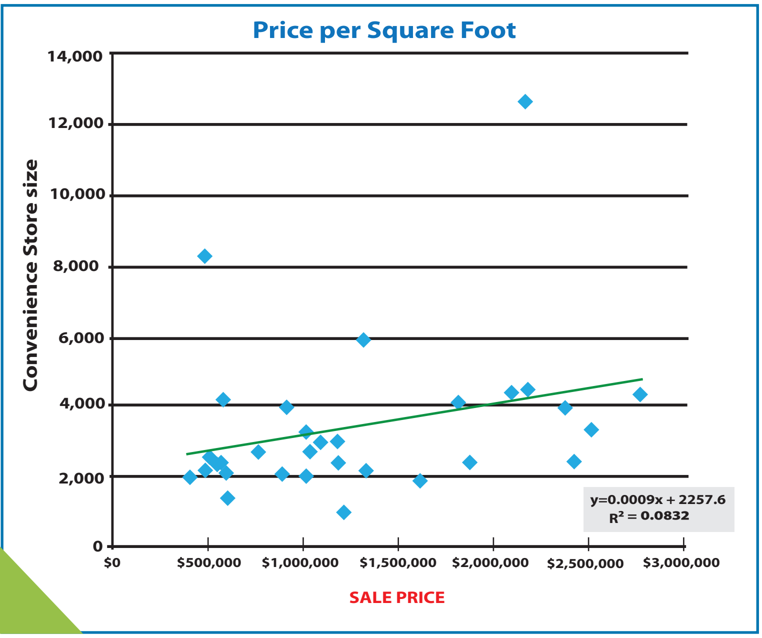
That means the appraiser has to know the revenue, cost of goods and expenses for each comparable sale in order to utilize these methodologies.

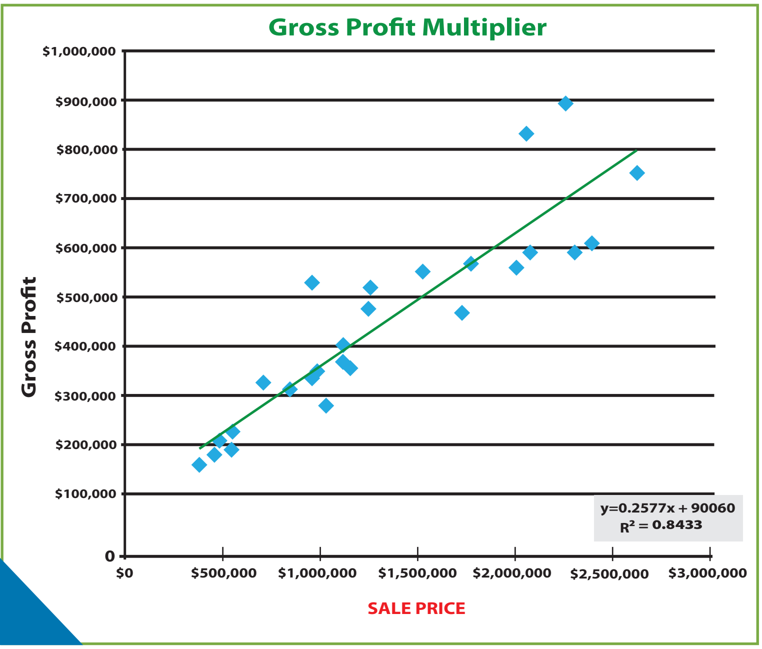
How do you get comparable revenue, cost of goods and expenses?

This usually comes from verifying the sale with one of the brokers on the transaction or the buyer or seller. The closing attorney will not usually be privy to this information. Other pertinent information to glean from a broker includes gallonage, inside sales, other income and profit margins for each. Establishing a good rapport with convenience store brokers, buyers and sellers is critical for appraising the property type. While appraisers share this data, it is best practice to verify the information. The difficulty in acquiring this data is one reason these property types are so difficult to appraise.

Are you certain the GPM is a better methodology than the price per square foot?

See the regression analysis below. The graphs represent analysis of 31 going concern convenience store sales.





	Coefficient of Variation	R2 Value
Price per Square Foot	0.62	0.0832
Gross Profit Multiplier	0.19	0.8433

The coefficient of variation represents the ratio of the standard deviation to the mean, and it is a useful statistic for comparing the degree of variation from one data series to another, even if the means are drastically different from each other.

The R^2 value explicitly expresses the strength of each data set. Essentially, the closer the R^2 value is to 1, the better the data.

It is evident from the data set, as well as the regression analysis graphs, the buyers are fixated on a store's profitability, not its size. That is not to say the size of the store plays no role. A larger store being underutilized may command a higher GPM due to the potential upside seen in converting the barely operational laundromat into a food service component. Even so, the driver is still gross profit, not size.

What to Expect in Part 2

Having established the complexity of the convenience store appraisal, Part 2 of this article will discuss common issues arising with right of way projects impacting convenience stores. Some topics we will cover include how and when loss of an access point impact the stores, as well as how easements (especially temporary construction easements) impact convenience stores. We will also review several case studies of impacted stores.

Have Questions for Us?

We realize this is a broad overview of issues related to appraising a complicated property type. Please reach out to us with any questions you might have. We will do our best to give or find an answer. Please visit *nxnwconsulting.com* for more information. ✪

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