AVOIDING DOUBLE COUNTING IN COMPENSATION

Coordinating business valuation and real estate appraisals in expropriations

BY PREM LOBO, CPA, CA, CBV AND CATALINA ANGHEL, CPA, CA, CBV

It is not uncommon for business valuation and real estate appraisal experts to be retained concurrently in expropriation proceedings. If a business is operating on land that is required for a public project, it's possible that the property owner will suffer from both business losses and a loss of property value.

Business Valuation vs Real Estate Appraisal

Generally, business valuators are retained to opine on two types of losses. One is the loss of business value that occurs when there is a full taking of land and it is not possible to relocate a business operating on it. The second type is business losses, which could result from a full taking of land where it is possible to relocate a business, a partial taking of land, or, sometimes, no taking of land (as a result of nearby construction activities for example).

On the other hand, real estate appraisers are retained to determine the market value of land taken for a full or partial taking or to determine the decline in the market value of the remaining land where there is a partial or no taking of land (sometimes referred to as injurious affection).

Significantly, even where there is no taking of land, compensation for injurious affection may still be available if damages were suffered as a result of construction or other expropriation related activities. For example, if a business is located adjacent to a roadway construction project, the value of that property can be impacted as a result of the construction. Moreover, if the construction makes it difficult for the business to operate normally, business losses can also become an unfortunate result.

Need for Consistent Assumptions

Both business valuators and appraisers have a duty to the adjudicator to impartially assist in determining the monetary compensation that would put a claimant back in the same economic position as it would have been in absent the expropriation. In fulfilling this duty, the compensation calculated by business valuators and appraisers should be based on a consistent set of assumptions to avoid issues like double counting. These assumptions often require coordination between the business valuators and the appraisers.

Avoiding Double Counting of Cash Flows

In a partial taking that results in injurious affection to the property as well as business losses, care must be taken to avoid potentially double counting with respect to the cash flows. Since these losses are typically considered in both the real estate appraisal and business loss calculations, it is not surprising to see losses inadvertently counted twice.

For example, assume that part of a hotel complex on a resort property is abutting a highway that requires widening. The widening requires the taking of part of the hotel's parking lot, as well as the demolishment of one of the hotel buildings on the property, and it becomes expropriated by a government authority in 2014. The result is a reduction in overall property size from 500,000 square feet to 400,000 square feet. In addition to reducing the property's square footage, the highway widening and demolition work results in financial setbacks due to intermittent hotel access restrictions and rerouting of traffic in the area until mid-2017. Once the highway-widening project is finally completed, the visibility and aesthetics of the hotel complex are both diminished.

An appraiser may calculate the following:

a) Market value of subject property at expropriation date, reflecting **pre**-expropriation square footage (500,000 sq. ft.) and **no impact** of the expropriation (no injurious affection). Assume the appraiser uses discounted a cash flow approach to arrive at market value, being **Cash Flow A**, resulting in market value of $30 million.

b) Market value of subject property at expropriation date, reflecting **post**-expropriation (i.e. lower) square footage (400,000 sq. ft.) and **no impact** of the expropriation (no injurious affection). Assume the appraiser uses discounted a cash flow approach to arrive at market value, being **Cash Flow B**, resulting in market value of $23 million.

c) Market value of subject property at expropriation date, reflecting **post**-expropriation (i.e. lower) square footage (400,000 sq. ft.) and reflecting impact of the expropriation (injurious affection, due to loss of visibility etc.). Assume the appraiser uses a discounted a cash flow approach to arrive at market value, being **Cash Flow C**, resulting in market value of $20 million.

Given this scenario, the appraisal losses may be calculated as follows:

a) Market value obtained from **Cash Flow A** ($30 million) minus **Cash Flow B** ($23 million) = Market value loss of property expropriated ($7 million).

b) Market value obtained from **Cash Flow B** ($23 million) minus **Cash Flow C** ($20 million) = Injurious affection ($3 million).

These calculations are illustrated in the Components of Damages table below.

Components of Damages

Market Value Loss of Land
= Difference of $7 million

Injurious Affection
= Difference of $3 million

Potential Business Loss
= Difference of $1 million

Total Potential Compensation
= $11 million

Cash Flow A

Present value of $30 million

- Determined by appraiser
- Market value of subject property at 500,000 sq. ft. (pre-expropriation)
- Does not reflect impact of expropriation (injurious affection)

Cash Flow B

Present value of $23 million

- Determined by appraiser
- Market value of subject property at 400,000 sq. ft. (post-expropriation)
- Does not reflect impact of expropriation (injurious affection)

Cash Flow C

Present value of $20 million

- Determined by appraiser
- Market value of subject property at 400,000 sq. ft. (post-expropriation)
- Reflects impact of expropriation (injurious affection)

Actual Cash Flow

Present value of $19 million

- Determined by business valuator
- Reflects **Cash Flow C** and incremental temporary impact of construction work during construction period
- May also reflect impacts unrelated to expropriation which may have to be identified and removed, as applicable

Adding Business Losses to the Mix

When exploring whether any business losses exist—in addition to the property losses already mentioned—the business valuator needs to understand which factors are accounted for/reflected in calculating Cash Flow C. For instance, if Cash Flow C reflects lower lease rates due to loss of visibility, but does not reflect a reduction for the temporary impact of construction activities, additional business losses may be applicable unless the appraiser considered those in their valuation under injurious affection. On the other hand, if Cash Flow C reflects not only the loss of visibility but also includes reductions in cash flow due to construction related disruptions, then potentially all of the business loss has already been reflected in the difference between Cash Flow B and Cash Flow C, and, therefore, has been reflected in the injurious affection calculated by the appraiser.

If it has been established that Cash Flow C does not account for/reflect all business losses, then calculating business losses should include a comparison of Cash Flow C with actual cash flow following the taking. If actual cash flow is lower, this suggests a possible business loss. As shown in the table, this potential business loss is approximately $1 million. Of course, further analysis is necessary to see if such difference between Cash Flow C and actual cash flow is exclusively due to the taking, or whether it is partially the cause of unrelated factors, such as competition or the economy, and therefore only partially claimable.

When Double Counting Occurs

If a business valuator were to calculate business losses as the difference between Cash Flow A and the actual cash flow, business losses would be double counted with the market value of land and injurious affection.

Similarly, if business losses were calculated as the difference between Cash Flow B and actual cash flow, business losses would be double counted with injurious affection.

To avoid potential duplication of losses, business valuators and appraisers need to understand what factors are accounted for/reflected in the various cash flows used in calculating appraisal losses and business losses, as using the inappropriate set of cash flows could result in double counting of losses. In this regard, early coordination between the appraiser and business valuator will prove invaluable in ensuring that all properly compensable losses are quantified, while minimizing the risk of double counting.

Considering Market Rents

In some contexts, there may an expropriation of land and a business that operates on the property. The business may or may not pay fair market rent in relation to the property. In order to value the business and in calculating cash flow used in the valuation, business valuators may have to reflect a fair market value rent figure (or normalize the rent actually paid by the business). This generally has to be consistent with the rent determined and used in the appraisal of the property. For example, if the rent actually paid by the business is below market rate and the business is valued using this lower rent expense figure, this will overstate the value of the business.

Meanwhile, if the appraiser has valued the property assuming a higher fair market rent, this will result in a higher appraised fair market value of the property. As such, there is an inconsistency between the rent figures used in the valuation and appraisal exercises, resulting in potential overcompensation. It is important for the rent figures

"...compensation calculated by business valuators and appraisers should be based on a consistent set of assumptions to avoid issues like double counting..."

used in the valuation and appraisal to be consistent to avoid such overcompensation.

Addressing Land and Leasehold Improvements

Appraisers should clearly indicate what assets and liabilities (land and leasehold improvements) have been included as part of their appraisal. If a valuation is based on adjusted net book value, the business valuator should ensure that the fair market value of these assets are not reflected again in the business valuation—or are otherwise adjusted—to avoid double counting.

For example, with a complete taking where a business cannot relocate and is terminated, if the appraiser has included the value of leasehold improvements in the market value loss conclusion, the business valuator should not duplicate this in their business valuation. If the appraiser has not included the value of leasehold improvements, the business valuator should consider whether leasehold improvements should be included in the business valuation at full replacement or depreciated replacement costs, and they should consider whether there are any betterment issues to address.

Cost Considerations

Care should be taken to ensure that certain costs are considered by either the appraiser or the business valuator—but not both. Specifically, consideration should be given to out-of-pocket costs incurred by a business on disposition of a property, ongoing capital expenditures required to keep a business operating and/or environmental remediation costs. A business valuator should generally consider these costs in the business valuation as long as they were not already included by the appraiser.

Borrowing Capacity

An appraisal is performed on a debt-free basis and therefore may not have considered whether there is any unused borrowing capacity available to the property owner. As such, the business valuator may need to adjust for this and reflect an increase in the valuation of the business.

Betterment

Some expropriation statutes may specify that any betterment ascribing to a property owner from an expropriation can only be set-off against injurious affection to the owner's land or remaining lands. It may be important to consider whether the betterment in question is unique and specific to the expropriated property as opposed to a benefit that is available to all neighboring landowners. This is an analysis that is usually undertaken by appraisers.

Start of Loss Period vs. Expropriation Date

In some cases, facts may suggest that the start date for quantifying business losses may be earlier than the expropriation date. This may occur when the claimant can prove that expropriation impacts were experienced prior to the expropriation date, such as when lower lease rates are demanded by tenants in anticipation of an impending expropriation. Business valuators and appraisal experts may need to review relevant documents to determine if an earlier date is appropriate in quantifying business losses, and whether certain detrimental impacts to cash flow noted prior to the expropriation date were indeed the result of the impending expropriation.

In Summary

In expropriation proceedings, coordinating certain aspects of the compensation calculated by business valuation and appraisal experts is of paramount importance. By discussing potential overlapping areas of compensation, such as cash flow streams, market rents, leasehold improvements and various costs, valuators and appraisers can avoid double counting and other issues associated with calculating losses.

The early coordination between appraisers and business valuators is invaluable in ensuring that all compensable losses are quantified, while minimizing the risk of duplication.✪

Prem Lobo, CPA, CA, CBV, is a Principal at Cohen Hamilton Steger & Co. Inc., specializing in the quantification of damages, business valuations and forensic accounting. Located in Toronto, Canada, his practice now encompasses various jurisdictions across North and South America. He has been recognized by the Canadian Institute of Chartered Business Valuators (CICBV).

Catalina Anghel, CPA, CA, CBV is an Associate at Cohen Hamilton Steger & Co Inc., where she specializes in business valuations, quantifying economic damages and forensic accounting investigations. She has expertise in expropriation proceedings, shareholder disputes, financial reporting and general business consulting.