VALUATION Viewpoint
Summer 2020
Vol 25 No 2
SHENEHON
BUSINESS & REAL ESTATE VALUATIONS

Valuing Companies and Real Estate During COVID-19

by Madeline Strachota

Assumptions about the future are at the heart of valuation. Despite being a largely quantitative process, valuing a company or real estate relies on professional judgement and expectations about the future. The 2020 Global Pandemic is unlike any other economic crisis and poses unique valuation challenges. Sure, it has similarities to the economic impacts of the Spanish Flu, 9-11 terrorist attacks, Savings and Loan Crisis, and several other similar economic downturns. However, the Global Pandemic is widespread, impacts all industries, and lacks geographic concentration. Further, the makeup of the U.S. economy is more technologically advanced, global, and services-oriented than it was during the first half of the 20th Century. Given the novelty of this crisis, past recoveries are only modestly reliable predictors of the future.

Therefore, we consider the following data, behavior, and collective assumptions in the marketplace to understand how value is impacted since the onset of the pandemic during the first quarter of 2020:

National Market Trends & Value Indicators

High Qual. Institut'l Grade	Value ∆ Over Past 12 Mo.
Office	-7%
Mall	-33%
Strip Retail	-14%
Industrial	6%
Apartment	-4%
Health Care	-6%
Lodging	-25%
Manufactured Home Park	8%
Self-Storage	-1%
Student Housing	-12%
	YoY Change
New Housing Starts - Q1-2 Midwest*	6.02%
Productivity**	0.70%
U.S. Unemployment***	200%
Consumer Confidence Index****	-19.26%

Real Estate Indicators from Green Street Advisors CPPI Report, *Source: St. Louis FRED, ** 1Q 2019/1Q 2020) – Source: Real GDP, St Louis FRED, *** June 2019/June 2020)– Source: Bureau of Labor Statistics, **** June 2019/June 2020 – Source: The Conference Board

- Some sectors are on the brink of collapse due to the 2020 Global Pandemic—specifically, hospitality, energy, retail, and transportation. While other sectors are thriving—such as supermarkets, certain online retailers, and off-sale liquor stores. The real estate associated with these industries have fared similarly. Further, sectors and property types that were considered more "recession proof" like student housing and senior housing, have not fared well during the pandemic.
- Forty percent of mergers and acquisitions (M&A) deals in progress at the beginning of the pandemic have been put on hold while only 14% of deals that were in-progress halted. Even so, M&A professionals believe that M&A activity will return to levels seen before the COVID-19 pandemic in 1-2 years (according to Alliance of Merger & Acquisition Advisors).
- As of June 2020, there was a record amount, $1.45 trillion globally, of "dry powder," which is the money that investors have committed to private-equity funds that has not yet been spent. This is in spite of several private equity owned retailers that have filed for bankruptcy in the midst of the 2020 Global Pandemic.
- There has been a significant reduction in large real estate deal volume (deals $10 million or greater). As of July 2020, total deal volume in the U.S. was 30% lower than it was a year ago, according to Real Capital Analytics.
- Analysts report seeing 5-35% erosion in prices for commercial real estate, with residential and industrial classes being the least negatively impacted and retail, hotels, and central business district office classes being the most impacted, according to Real Capital Analytics.

continued on page 5

More in this Issue:

Are You Asking the Right Appraisal Question?

by John Schmick

Uniform Standards of Professional Appraisal Practice (USPAP) are the minimum appraisal requirements that guide appraisers in providing appraisal services. In Minnesota, these requirements are codified into law requiring state licensing of real estate appraisers (Chapter 82B.195). An important part of USPAP is the Scope of Work Rule which requires that the appraiser "… identify the problem to be solved; determine… the scope of work necessary to develop credible assignment results". Identifying the problem to be solved starts with client discussions to determine what questions they have relative to their real property interests. While many assignments simply need to determine market value for business or personal decisions, in the area of litigation or transactions, asking the wrong appraisal question can nullify the entire appraisal. This is especially true with ground leases and easements where less than the whole property is burdened with lease/easement. A recent pipeline case in California illustrates the pitfall of asking the wrong appraisal question.

"...asking the wrong appraisal question can nullify the entire appraisal."

In 1953, a local water company entered into a pipeline easement agreement on a branch of a national railroad corridor. Terms called for the annual rent to be adjusted to market rates every ten years. For adjustment year 2013, the two sides had drastically different opinions on what market rent should be. The appraiser for the railroad opined to $862,000 annually while the appraiser for the pipeline company opined to $125,000 annually. Both appraisers used a common form of Across-the-Fence (ATF) methodology but used different sales data, different adjustments, and different rates of return. Ultimately both appraisal reports relied on the wrong appraisal question and were unreliable. A summary of the appraisals is presented in the graph in the lower lefthand corner.

	Railroad	Pipeline Company
Report Date	March 2018	February 2014
Defined Larger Parcel	Easement Area	Easement Area
Across-the-Fence price (ATF)	$73.25 per sf.	n/a
Adjusted Land Price	n/a	$32.05 per sf.
Corridor Factor	1.50 x ATF	n/a
Corridor Value	$109.88 per sf.	$32.05 per sf.
Usage Factor	50%	30%
Rate of Return	8.38%	7.0%
Annual Rent	$862,000	$125,000

To understand the appraisal question, we first look back to the start of the easement in 1953. At that time, the pipeline company wanted to occupy excess space on the railroad corridor and the railroad was willing to permit such use. Excess railroad space is defined as space not currently needed for railroad operations. General valuation questions at that time were how much of the railroad's property would be occupied and how much was the railroad's land worth? These questions form the framework of what does the railroad give up or lose and what is the appropriate compensation?

"Over time the original appraisal question can get lost as the parties try to simplify the issue."

Over time the original appraisal question can get lost as the parties try to simplify the issue. Staff for either party may not understand the significance of correctly defining the appraisal question and communicate the assignment as valuing an easement for annual rent adjustment. In this case, both appraisers defined the subject property as the easement area. The subtlety changes the framework from what does the railroad/seller lose or give up to what does the pipeline company/buyer own or control?

While the subtle change in defining the appraisal question seems harmless, the results are far reaching. By defining the subject property as the easement area, one appraiser attempted to define the larger parcel as the easement area, defining unity of ownership as the pipeline company, unity of use as a subsurface water pipeline, and contiguity as an assembled pipeline corridor. The appraiser carried this theme into the highest and best use defining economic demand for the pipeline easement was 100% because water is in high demand in California and if the current pipeline company did not provide the service, another pipeline company would. Nowhere in either appraisal did the two appraisers consider the whole railroad property, the economic profile of the corridor, or

Are You Asking the Right Appraisal Question?

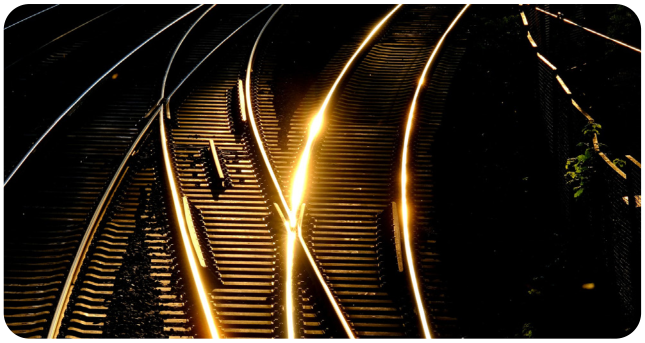
continued from page 2

any portion of the railroad corridor outside the easement area. This is a common flaw in ATF corridor valuation appraisals.

Understanding the assignment and identifying the appraisal problem is related to the intended use of the appraisal. In this case, the intended use was to assist two parties in negotiating a fair market rent for the next adjustment period. The pipeline company owned an easement (dominant estate) that gave it the right to occupy space on the railroad's property. The railroad retained fee simple interest in the entire corridor subject to agreements to allow others to occupy space within their ownership. Thus, the valuation question starts with identifying the railroad's larger parcel of land from which a portion is burdened by the pipeline easement. If rent is to be paid on that portion of railroad land value captured by the easement, then the larger parcel must be defined as railroad land and not the ownership rights of the pipeline company.

"While the subtle change in defining the appraisal question seems harmless, the results are far reaching."

By failing to understand the appraisal problem and the appraisal question, both appraisers failed to research and analyze several important relevant facts that impacted valuation. First, both appraisers acknowledge that railroad operations on the active tracks were low volume. Using estimates of railcar activity and average operating income attributed to land, per railcar per mile of track, it was discovered that current rail operations supported a land value for the center track section of less than \$0.05 per square foot. This is less than one percent of typical land prices in the area. The track section occupied 34% of the corridor width.



Second, land area occupied by pipelines was 29% of the corridor width. The remaining 37% of corridor width had not attracted any economic demand in over sixty years. As a result, a total of 71% of the corridor width produced little to no income to the land. Under the ATF methodology used by both appraisers, this type of analysis is not performed.

Ultimately, using an incorrect appraisal question led to a very narrow understanding of the assignment and a land value analysis that was significantly higher than the economic profile of the railroad land. Imagine standing on the railroad property with your left foot on the pipeline easement area and your right foot on the vacant excess land. How would your appraiser answer the question: How can the land under my left foot be so valuable when the land under my right foot has no economic demand for over sixty years when it all has the same owner (railroad), is used for the same purpose (corridor), and is contiguous? Facing this and similar questions, this case settled shortly after exchanging reports, including a review report, and before scheduled arbitration. The settlement was a compromise reflecting an ongoing business relationship but favored the pipeline company.

While the case presented here may be an extreme example of using the wrong appraisal question, this issue is not limited to railroad corridors. Overlapping easements, ground leases, sale of property with existing easements, multi-parcel properties, and other situations can suffer from incorrect appraisal questions which can impact assignment results. When engaging an appraiser (real property, business, or personal property), set aside some time to thoroughly discuss the intended use, intended users, and the appropriate appraisal question to be addressed in the assignment. This will minimize unwanted surprises in the use of the appraisal at a later date.

Uniquely Priced Assets: Professional Sports Teams

by Thomas Blomgren

As the world is shuttered due to concerns over the outbreak of COVID-19, many have discussed the effects of the outbreak on the sporting world. The sudden disappearance of sports will erase at least $12 billion in revenue and hundreds of thousands of jobs in the United States, according to a recent study conducted by ESPN. Now is a good time to ask, how does this disruption in revenue impact the value of this $100 billion-dollar United States sports industry? As a business valuation firm, Shenehon Company understands the unique aspects involved in the valuation of professional sports franchises. These businesses require special treatment in order to find their accurate value.

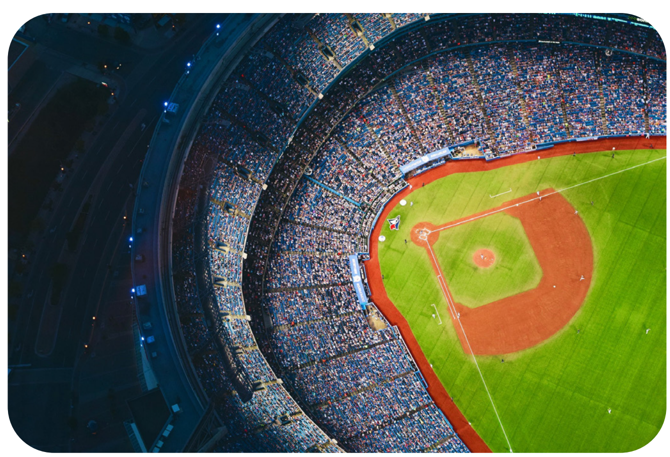
"...sports franchises are many times treated as a "trophy" asset, which means that they attract wealthy individuals in a way similar to other luxury goods."

Forbes last released their annual rankings of the 50 most valuable sports franchises as of July 2019. One trend over the recent term has been the exploding growth of team valuations. For instance, in 2012, Manchester United was the only sports team valued at over $2 billion dollars. Now, every one of the 50 franchises are valued at over $2 billion dollars. Locally, the only Minnesota franchise to make the list was the Minnesota Vikings, at $2.4 billion. Forbes does not release its propriety models to valuing sports franchises; however, we at Shenehon Company know that it is not as straight-forward as valuing other privately held companies.

The three traditional approaches to valuing a private company are: the income approach, the market approach, and the asset-based approach. Each approach has its own unique way of assessing value:

- The income approach, most often via the discounted cash flow method, is where the value is estimated based on the cash flows a business can expect to generate over its remaining useful life.
- The market approach is where the value of a business is determined by using one or more methods that compare the subject to similar businesses, business ownership interests, securities, or intangible assets that have been sold.
- The asset approach is where value is estimated based on the value of assets net of liabilities.

However, professional sports teams are more difficult to value based on traditional business valuation techniques for several reasons. First, the valuation of professional sports franchises is driven higher by the severe lack of supply. There is a limited supply of professional sports teams in the four major sporting leagues in the US and Canada (NFL, NBA, MLB, and NHL), with 123 total franchises. Therefore, sports franchises are many times treated as "trophy" assets, which means that they attract wealthy individuals in a way similar to other luxury goods. Next, the income approach is not an accurate approach to valuing sports franchises due to low expected cash flow. Most owners expect to realize their return on their investment at the time of sale, not from cash distributions on the investment during ownership. The market approach, by



Professional Sports Teams

continued from page 4

comparing the franchise to other previously purchased franchises, comes closest to finding the accurate fair market value. Even then, unique aspects of a sports franchise, such as the local media market, sponsorship and stadium revenue, revenue sharing mandated by collective bargaining agreements, and brand strength, must be accounted for in each valuation.

To use a recent example, the Houston Rockets were purchased by wealthy businessman, Tilman Fertitta, for $2.2 billion in 2017. According to Forbes, the Houston Rockets had approximately $296 million in revenue in 2017. This implies a revenue multiple of 7.4 for ownership of this private company, which is astronomically high. For comparison, the average entertainment company in the United States trades at a revenue multiple of 4.08, according to data compiled by NYU professor Aswath Damodaran. However, the Houston Rockets compete in a large media market and historically have been popular overseas, leading to greater franchise prestige. This makes them an attractive asset to own. Another unique franchise is the New York Yankees, who are the second most valuable sports franchise in the world at $4.6 billion. The Yankees can achieve this high valuation due to exceptional brand value, size of media market, and unique local television rights that make the franchise a "trophy" of the modern sporting world, even with operating income of $30 million.

"These unique challenges are the dreams of the modern appraiser."

The multiples implied in transactions of professional sports franchises highlight the unique valuation approach to these businesses. The distinct honor and prestige of owning a sports franchise serves as its own social currency, which is a distinguishing consideration when appraising these assets. Given that buyers seek benefits beyond the expectation of future cashflows throughout their ownership tenure, there is a significant difference in valuing sports franchises from valuing other businesses. These unique challenges are the dreams of the modern appraiser.

Valuing Companies and Real Estate During COVID-19

continued from page 1

These general trends cannot be applied universally. For example, in the real estate market, smaller, local-to-local transactions are occurring at generally normal paces and prices. Additionally, restrictions around travel make the due diligence process harder for institutional investors, which has caused deal slow-down and price compression in institutional grade investments. Another divergence from high-level trends are cap rates in strip mall retail, which have decreased in second quarter 2020 by 6 basis points, whereas cap rates for regional malls have increased 72 basis points. Furthermore, there is a high level of private capital reserved to pursue investments, indicating that money is likely to be deployed and may take advantage of distressed selloffs.

The impacts of the 2020 Global Pandemic must be analyzed on a case-by-case basis—not every asset is faring the same through this recession. Negative effects are temporary and the long-term economic consequences of this pandemic remain unknown. While the exact timing of a rebound is unclear, quality companies with strong fundamentals should be able to recover. Economic fundamentals were strong preceding the 2020 Global Pandemic and the negative impacts of COVID-19 could be repaired quickly if there is widespread containment of the virus. However, the longer the economic turmoil progresses, the harder it will be to achieve a V-shaped recover. The takeaway: the popularized phrase "COVID-19 discount" is a misconception, and while it may apply in certain transactions, it is not universal. A careful analysis of each valuation problem and the marketplace informs the valuation approach applied by Shenehon appraisers, especially during this unprecedented time.

Market Transaction
Real Estate

Buyer: TGLDC, LLC (Hillcrest Development, LLLP)
Seller: Micom Corporation
Property: 475 Old Hwy 8, New Brighton, MN
PID: Two (2) Parcels
293023420039 and 293023420038
Sale Price: $75,000
Website: www.highway8businesscenter.com

Sale of New Brighton Industrial Property

In December 2019, TGLDC, LLC, an entity owned by Hillcrest Development, LLLP purchased approximately 63,000 square feet among three industrial buildings situated on approximately 3.83 acres of land in New Brighton, Minnesota from Micom Corporation for $75,000. The property had been on the market for over two years, and there were no other viable offers made at the time of sale. Additionally, TGLDC, LLC had made a previous, higher offer on the property that had been declined. Since closing, TGLDC, LLC has succeeded in reducing the property's assessed value and obtaining grant funding awards to mitigate the property's contamination.

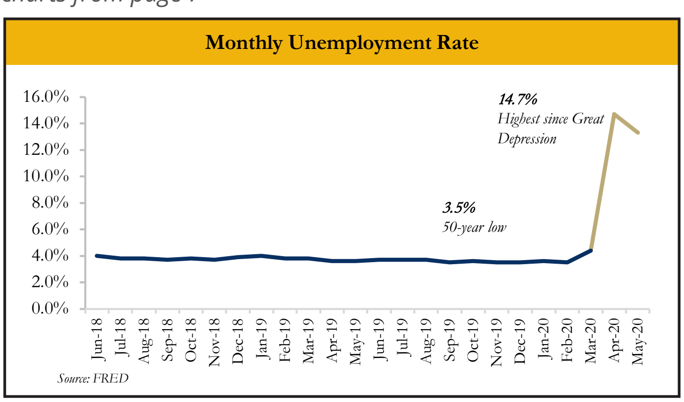
Micom Corporation, which had used the property for circuit board manufacturing, had been cited for hazardous waste violations by the Minnesota Pollution Control Agency (MCPA) as recently as 2016. The property has a high level of deterioration and contamination that includes lead, copper, and mercury impacted dust and concrete within the buildings and VOCs in vapor. Limited soil and groundwater impacts exist as well, but are unnecessary to address with the current redevelopment strategy. TGLDC, LLC plans for general industrial uses including manufacturing, warehouse, and office and has received a lease commitment from one tenant. The property also permits outdoor storage. The buildings have loading door docks, drive-in doors, sprinklers, and heavy power.

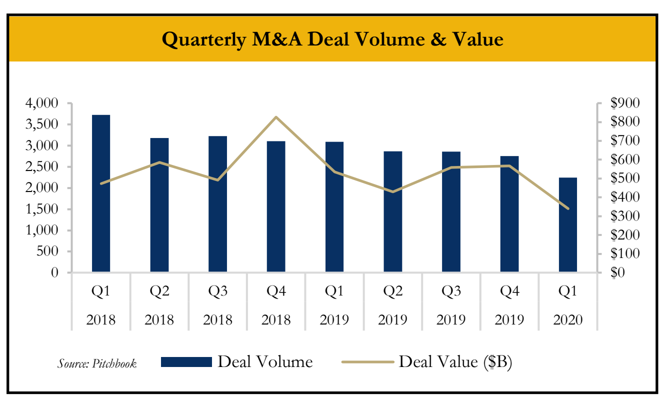
The developer's estimated cost for environmental cleanup is approximately $1.05 million, which is part of a total estimated redevelopment budget of $3.1 million. In May 2020, TGLDC, LLC succeeded in reducing the total assessed value on both parcels from $1,263,600 to $150,000—a necessary step toward achieving grant awards. TGLDC, LLC applied for four different grants to support contamination mitigation: a MN Department of Employment and Economic Development (DEED) award amount of $82,170; a Ramsey County Environmental Response Fund (ERF) award amount of $21,435, both to assist with installation of a vapor mitigation system to address vapors within the building; a Metropolitan Council Tax Base Revitalization Account (TBRA) award of $400,000 to assist with interior metals scrubbing; and a Ramsey County ERF pending request of $200,000 to also assist with interior metals scrubbing.

Rendering of Highway 8 Business Center   Source: Hillcrest Development, LLLP

Market Transaction: Business

charts from page 7





Market Transaction Business

by Jared Rance, Managing Director, Hennepin Partners

The Evolving Impact of COVID-19 on M&A

The impact of COVID-19 has been swift and far reaching on public health, travel and economic activity globally. Since the detection of the Coronavirus in late 2019, global stock markets sold off (and have since rebounded), unemployment spiked, companies across nearly every industry altered their operations and interest rates pushed lower as central banks implemented unprecedented monetary intervention. Adding to the market disruption was plummeting demand for oil, extreme volatility in oil prices and continued global trade tensions. As a result, uncertainty became the prevailing theme business owners and investors were left to deal with.

The immediate impact on the M&A market is evidenced by a significant number of active M&A transactions being paused or pulled from the market and new transactions waiting to enter the market. Leading into the pandemic, the M&A market had already exhibited signs of a slowdown with deal volume down in 2019 versus 2018. This all points to a significant reduction in 2020 deal volume compared to the peak of 2018. Valuations are also likely to see a correction, driven by lower levels of available debt (and potentially higher debt pricing) and the incorporation of higher risk/return requirements for equity investors driven by the lack of clarity surrounding economic outlook. Despite the above, select transactions are proceeding with activity driven by certain sectors (healthcare, tech/software), late-stage transactions involving a buyer acquiring a highly-strategic asset, stable high-quality assets and increasing volume of distressed/turnaround M&A transactions.

For companies that performed reasonably well during April/May/June that can also substantiate a return to 'normal' later in the summer with good visibility of forward revenue, there is a near-term path to engage in M&A. One thing remains clear, the broader market wants a return to "normal" as demand for high-quality deals continues to outstrip supply, private equity buyers have significant capital to deploy and pockets of corporate buyers have solid balance sheets. This said, the return of a healthy M&A market is contingent on clarity returning to investors' ability to validate forward looking revenue assumptions and debt capital markets being supportive of prevailing valuations.

The Road Ahead - Industrial M&A

As current and/or eventual sellers of businesses evaluate "what's next", particularly for industrial companies, the market is likely to have an increased focus on high-quality companies. Quality can be defined across a number of attributes including diversification of markets and customers served, defensibility of market position, sustainable competitive advantages, quality of leadership team and stability / visibility of revenue outlook. The aforementioned attributes are validated through consistent historical revenue growth/performance and profitability. Those businesses with "repair/replacement" and/or non-discretionary demand drivers that have the margin profile to substantiate differentiation are positioned well to drive robust interest in the early innings of the post-COVID M&A market.

Hennepin Partners Advises ASPEQ Heating Group on its Sale to Industrial Growth Partners

The flight toward quality, as mentioned above, in industrial M&A is seen during the late stages of a cycle, when acquirors are focused on how the target will perform during the next cycle as well as during the initial phases of a recovery, when speed and length of the recovery is unknown and investors are seeking high-margin, strong cash flow companies with stability and diversification that have limited risk or reliance associated with any one customer or market. It was these elements, along with a well-developed organic and acquisition growth strategy that drove a high-degree of interest and resulted in a successful outcome in a recent Hennepin Partners closed transaction.

In late 2019, Hennepin Partners advised ASPEQ Heating Group ("ASPEQ"), a leading designer and manufacturer of custom-configured and highly-engineered electric heating and thermal management products to the industrial, commercial, military, marine and transportation markets. ASPEQ's combination of customer and market diversity, repair/replacement driven revenue and the quality of the leadership team made it an ideal candidate to not only drive growth but also weather the challenges associated either with an economic slow-down or that of an exogenous shock like COVID-19. Industrial Growth Partners viewed ASPEQ as an attractive fit with a strategy of investing in niche industrial companies with leading market positions, significant growth opportunities and stable/consistent drivers of revenue.

SHENEHON
BUSINESS & REAL ESTATE VALUATIONS

88 South Tenth Street, Suite 400
Minneapolis, Minnesota 55403
612.333.6533
Fax: 612.344.1635
www.shenehon.com

RETURN SERVICE REQUESTED

VALUATION VIEWPOINT NEWSLETTER INSIDE

SHENEHON COMPANY IS A REAL ESTATE AND BUSINESS VALUATION FIRM, serving both the private and public sectors throughout the United States. Our unique combination of real estate and business valuation expertise allows us to provide a wide range of services to offer innovative solutions to difficult valuation issues. Shenehon Company is commited to equipping its clients with the tools necessary to make informed and knowledgable decisions regarding their capital investments.

- Allocation of purchase price
- Asset depreciation studies
- Bankruptcy proceedings
- Charitable donations
- Commercial properties
- Condemnation
- Contamination impact studies
- ESOP/ESOT
- Estate planning
- Feasibility analyses
- General limited partnership interests
- Gift tax evaluations
- Going public or private
- Highest and best use studies
- Industrial properties
- Insurance indemnifications
- Intangible asset valuation
- Internal management decisions
- Investment counseling
- Land development cost studies
- Lease and rental analyses
- Lost profit analyses
- Marriage dissolution
- Mortgage financing
- Multifamily residential properties
- Municipal redevlopment studies
- Potential sales and purchases
- Railroad right-of-ways
- Special assessment appeals
- Special purpose real estate
- Tax abatement proceedings
- Tax increment financing
- Utility and communication easements

Contributors: Robert Strachota, President
Jared Rance, Managing Director, Hennepin Partners
Thomas Blomgren, Valuation Analyst
John Schmick, Senior Valuation Analyst
Madeline Strachota, Senior Valuation Analyst

SHENEHON
BUSINESS & REAL ESTATE VALUATIONS