Purchase Accounting Valuation for Various Real Property Assets

A Purchase Price Allocation ("PPA") estimates the Fair Value of certain tangible and financial assets acquired in accordance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 805, Business Combinations ("FASB ASC 805") and Topic 820, Fair Value Measurement ("FASB ASC 820"). The term "Fair Value" is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (FASB ASC 820-10-20). In particular, FASB ASC 820 prescribes that the measurement of the Fair Value of an asset or liability should be based on assumptions that market participants would use when pricing the asset or liability.

PPAs are required for every controlling transaction wherein the acquirer complies with Generally Accepted Accounting Principles ("GAAP"), with varying complexity based on the entities and/or assets involved in the transaction. Specifically, the real property valuation component of the PPA exercise can generally be delineated into two categories: conventional real property (manufacturing/industrial in business combinations) and complex real property (institutional/investment asset acquisitions). PPA assignments that include conventional real property typically comprise transactions in the manufacturing sector — whereby the owned real properties are operational manufacturing or warehouse facilities. These are not typically income-generating properties, and the Fair Value is therefore allocated between the buildings, the site improvements, and the underlying land (it's also noted that leased real property in this scenario would be subject to a favorable/unfavorable lease analysis). Further, these engagements are generally multi-discipline in that the allocation also includes machinery & equipment, along with various non-real estate intangible assets/liabilities.

Purchase price allocation assignments for complex real

FIGURE 1 COVENTIONAL VS. COMPLEX

CONVENTIONAL	COMPLEX
Tangible Assets	**Tangible Assets**
Buildings Site Improvements Land	Buildings Site Improvements Land Unamortized Tenant Improvements
Intangible Assets/Liabilities	**Intangible Assets/Liabilities**
Favorable/Unfavorable Lease (Leased Property Only)	Above Market Leases Below Market Leases Customer Relationships In-Place Leases Avoided Lease Origination Costs Assumed Debt

property typically include investment-grade, institutional properties like multi-tenant office buildings, shopping centers, apartment complexes, or regional malls (although any income-generating property with multiple tenants would be subject to the same FASB guidance as it relates to reporting requirements). As compared to real property asset classification for conventional PPAs for business combination purposes, complex real estate is allocated between the same buildings, site improvements, & land categories, but also includes various other tangible and intangible assets, which are discussed in **Figure 1**. Inherently, PPA assignments for this type of acquisition require experienced professionals versed in the codification, who are able to supportably guide both the acquirer and an audit team through the exercise.

Knowing the assets acquired and liabilities assumed, the Fair Value conclusions are then compared to the total transaction consideration (i.e., the purchase price). Given common variances between appraisal methodologies (cost, market, income), the appraisal conclusion is often an imprecise comparison to purchase price. Therefore, a pro-rata adjustment (either up or down) is applied to all measured assets. In less-common instances where this adjustment is material (say more than 3-5%), the excess value is recognized as goodwill. In the event that the Fair Values of the tangible and intangible assets/liabilities exceeds the total purchase price, the resulting gain is recognized in earnings on the transaction date, as outlined in FASB ASC 805 for bargain purchase procedures.

To further identify the specific valuation variances between purchase accounting for conventional and complex real estate, the following two examples are presented. The first describes the analysis and presentation of an allocation assignment for a typical operational automotive manufacturing facility. The second example represents an asset purchase of a trophy office building by a REIT.

CONVENTIONAL REAL PROPERTY: TANGIBLE ASSETS ONLY

In this scenario, traditional appraisal theory for an owner-user industrial facility is applied. As it relates to methodology, the most relevant and applicable approaches between the sales, income, and cost approaches are utilized in the Fair Value conclusion of the property. From this point, the Fair Value conclusion is allocated between the buildings, site improvements, and land. The underlying land is typically valued separately, and site improvement Fair Value is generally concluded via a cost approach. Deducting land Fair Value and site improvement Fair Value results in the Fair Value component attributable to the buildings.

COMPLEX REAL PROPERTY: TANGIBLE AND INTANGIBLE ASSETS AND LIABILITIES

While the preceding paragraph typically summarizes all steps on a PPA for conventional real property, the exercise for complex real estate includes the valuation of several other assets and liabilities. The genesis of these asset/liability classifications lies in the leased fee component of the property. That is, the buyer of an institutional multi-tenant office building or regional mall is not only purchasing the underlying land and the bricks & mortar, it is also acquiring all lease contracts in place, along with the various implications driven by those contracts. The following example describes these additional assets and liabilities, what they represent, and how their Fair Value is accounted for.

Similar to the first case, the Fair Value of all buildings, site improvements, and land are identified and allocated. However, as income-generating properties, the appropriate methodology varies to best reflect market participant application. As such, the property is typically valued on an as-vacant basis via the cost and income approaches. A cost approach is first modeled, which appropriately values the land and improvements with no consideration of leases in place. The cost approach is supported by a 'go-dark' income analysis, which capitalizes the future income stream associated with the property, but under the hypothetical scenario of complete vacancy, so as to exclude any contribution from the leases in place (which are valued separately). The sales comparison approach is also employed, but primarily as support to the Fair Value conclusion of the individual tangible and intangible assets in aggregate. This is due to the leased fee nature of similar investment-grade transactions, in which all real property assets are conveyed in one bundle or rights.

However, one additional tangible asset is typically present in these complex real properties—unamortized tenant improvements. This asset category represents the benefit or cost avoidance associated with previously incurred tenant improvements. It is often calculated based on the individual tenant square footage, the concluded market tenant improvement allowance, and the remaining lease term.

INTANGIBLE ASSETS & LIABILITIES ASSOCIATED WITH COMPLEX REAL PROPERTY

A significant variance in the appraisal process between conventional and complex real property for PPA purposes lies in the presence of intangible assets and liabilities. As noted previously, these intangible categories tie to the acquisition of lease contracts beyond the underlying land and improvements. Intangible assets/liabilities associated with institutional or investment-grade properties typically comprise above-market leases; below- market leases; customer relationships; in-place leases; avoided lease origination costs; and assumed debt. Beyond the quantification of each asset or liability, it's also necessary to understand the remaining useful life associated with each item for amortization purposes.

FAVORABLE/UNFAVORABLE LEASEHOLD ANALYSIS (ABOVE- AND BELOW-MARKET LEASES)

Beyond the value of the lease contracts in place, there are also potential assets or liabilities in the presence of lease contracts that deviate from the market. From the acquirer's perspective, above-market leases are considered an asset in that income is attributable to the contract beyond what would be available in the market. To the contrary, below-market lease contracts would be considered a liability via the income impairment throughout the term of the lease.

To determine whether or not in-place leases are favorable or unfavorable, contract leases and current listings of comparable properties are analyzed to determine a rental rate and expense structure typical of the market. If the contract lease rate deviates from the concluded market rate, the annual contract rent is subtracted from the annual market rent to determine the difference in annual cash flows for the remainder of the lease term. For above-market leases, it's reasonable to assume the tenant would decline any options to extend. For below–market leases, the remaining lease term is typically projected to include all defined, favorable option terms.

- Contracts with above-market rents have a positive Fair Value (i.e., an asset exists)
- Contracts with below-market rents have a negative Fair Value (i.e., a liability exists)

CUSTOMER RELATIONSHIPS

Customer/tenant relationships can theoretically impact contract rental rates and other pertinent terms associated with a lease. In the instance that a favorable customer relationship exists, benefits to the landlord may include higher renewal probabilities and above-market rental rates. This is an asset category without market consensus as to treatment — while certain real property appraisers will quantify customer relationships, others assert that such relationships are almost universally absent from the market.

IN-PLACE LEASE ANALYSIS

The valuation of in-place leases represents the value to the owner via the cost avoidance of lease-up costs. This component of the allocation essentially fills the gap between the as-vacant income analysis and the leased-fee income stream in place as of the transaction date. The quantification of in-place leases should include the lost rental revenue during the lease-up period — both base rent and any applicable expense reimbursements.

AVOIDED LEASE ORIGINATION COSTS

Beyond the value of avoided lease-up costs, a property owner would recognize an asset in the cost avoidance of leasing commissions and legal/marketing costs associated with the leases in place. To that end, the unamortized leasing commissions and legal/marketing costs associated with each individual lease should be measured. Similar to the valuation of unamortized tenant improvements, avoided lease origination costs are calculated with market leasing assumptions over the remaining term of each contract.

ASSUMED DEBT

PPA accounting guidance requires that notes payable and other long-term debt be assigned amounts "at present values of amounts to be paid, determined at appropriate current interest rates." Therefore, if a mortgage is assumed in the acquisition of a property, there may be an intangible asset to the extent that the assumed mortgage features a below-market coupon. Likewise, assumed mortgages featuring above-market coupons represent an assumed liability to the buyer.

In summary, real property valuation for the purpose of a purchase price allocation is inherently different than most appraisal assignments, in that it requires an understanding of accounting regulations and financial reporting guidelines. Within a PPA framework, there is further bifurcation between conventional real property assets (such as an operational manufacturing plant) and complex real estate (for example a class A office park). While conventional properties may follow more traditional appraisal methodologies, complex real estate

in the vein of institutional or investment-grade assets often feature intangible assets and liabilities that are not easily discernible. In these cases, it is imperative the valuation expert handling the purchase accounting is familiar with both the FASB ASC 805 guidance, and has the experience to supportably guide the acquirer and audit through the allocation.

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