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 (manufacturing/industrial) real property and complex (institutional/investment) real property. 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 is 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 and equipment, along with various non-real estate intangible assets/liabilities.

Purchase price allocation assignments inclusive of complex real property typically include investment-grade institutional facilities such as multi-tenant office buildings, shopping centers, 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 the real property asset classification for conventional PPAs, complex real estate is allocated between the same buildings, site improvements, and land categories, but also includes various other tangible and intangible assets, which are discussed on the following pages. Inherently, PPA assignments for this type of acquisition require experienced professionals versed in the codification, and able to supportably guide both the acquirer and an audit team through the exercise.
Given the assets acquired and liabilities assumed, the Fair Value conclusions are then compared to the total transaction consideration (i.e., the purchase price). To the extent that the purchase price exceeds the Fair Value of the non-debt net working capital and tangible and intangible assets/liabilities, 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 accounting for conventional and complex real estate, 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.

1 | 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.

2 | 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 and 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 income approach; more specifically, a discounted cash flow is modeled to identify 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). This as-vacant income approach is supported by a cost approach, which appropriately values the land and improvements with no consideration of leases in place. 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 of 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 and 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, and avoided lease origination costs. Beyond the quantification of each asset or liability, it is 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 is 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)

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.

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 the FASB ASC 805 guidance and has the experience to supportably guide the acquirer and audit through the allocation.

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