

Appraiser's Goal

The Appraiser's Goal: Providing Realistic Valuations; Finding the Best Approach

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Every ASA machinery and equipment appraiser is obliged to consider the three approaches to value when conducting an independent valuation. These are namely the Cost, Market and Income approaches, which have become the standard methods for appraising assets of all kinds since the 1960's and more recently formalized in the 1980's for machinery and equipment.

A description of the philosophy behind each approach is as follows:

Cost Approach

The cost approach involves the principle of substitution, whereby the value of a piece of equipment is equal to the current replacement cost new of the asset less all forms of depreciation. Based on the age, condition, and current market the asset is working under, various levels of physical, functional and economic obsolescence would be subtracted from replacement cost to arrive at current value. Physical depreciation is typically on a straight-line basis and is calculated by estimating the remaining useful life of the asset against the overall normal life when new. Functional obsolescence represents any inherent inefficiencies to the subject being appraised compared with newer technology while economic obsolescence takes into account factors within the specific marketplace, such as changes in demand for product, interest rates, production costs, environmental issues and increased competition.

Simply stated, the replacement cost new for the equipment, less all forms of depreciation equals the current fair market value for the asset.

Income Approach

The income approach relates to the equipment's ability to produce an estimated future cash flow over the remaining life of the asset that supports its ongoing use and associated value. In essence, the value of equipment can be measured by calculating an expected future benefit to its owner.

This method, although widely accepted in the appraisal community, can only be relied upon if sufficient financial data is available to the appraiser for the asset itself and the industry under which it operates. The income approach is more frequently relied upon when an appraiser is confronted with valuing an entire facility and operating data is provided on the entire business. It is possible, however, to create an income approach analysis on an individual asset basis, so long as the appraiser can associate a pro rata share of revenue and expenses to the subject piece of equipment. From there, a

discounted cash flow analysis is completed that will arrive at an estimate of fair market value.

Market (Sales Comparison) Approach

The market approach is the most widely known and accepted theory of appraising equipment, which involves the analysis of recent sales and asking prices of similar properties to the subject equipment. The analysis is completed by discovering available market data on recent sales and offerings of similar equipment and adjusting these comparables to match the subject being appraised. Differences in age, condition, capacity and market sold in, are some of the factors adjusted to create a more compatible match to the subject equipment. After adjusting the comparables, the appraiser uses their prudent judgment to decide how much weight each comparable carries to arrive at current fair market value for the subject using the market approach.

Consideration and Appropriate Application

As noted earlier, the ASA appraiser is required to consider all three approaches to value, however, they need not rely on all three for every engagement. In some cases, sufficient data may not be available to utilize an approach, while in other instances, the scope of the appraisal does not dictate use of a certain methodology.

For example, the income approach will generally not be utilized when the equipment is being valued on a “removal” or “as-is, where-is” basis, since this scenario does not account for any future revenue generation from the asset where it was previously installed.

Another example is where the equipment has very limited secondary market experience and recent comparable sales are rare, if not nonexistent to research and analyze. This is common with certain types of custom-made equipment or in an industry that manufactures a product with a limited market and number of manufacturers.

In cases where more than one approach can be relied upon, the appraiser will typically weight each one according to the confidence they have in the data supporting them and it’s pertinence to the scope and premise of value. For example, if the subject equipment is being sold as an ongoing concern to a third party, the income approach may be more heavily weighted if sufficient financial data is available to the appraiser. Or in the case of a liquidation scenario, the market approach may be the key driver to value given its relevance to the type of sale being considered. If sufficient comparable sales are not available to rely more heavily on the market approach, the appraiser may rely more on the cost approach or create a “hybrid” cost/market analysis to arrive at their conclusions of value.

These issues arise very often when appraisers work with Equipment Managers on end-of lease dispositions, bankruptcies, repossessions and other situations where the lessor’s equipment is being sold either to the current operator or to a third party. The specific re-sale scenario and value definitions required will assist in determining the appropriate methodologies used and relied upon.

To put these appraisal theories into practice, let's consider a few interesting examples of asset management situations that occur in the everyday life of an Equipment Manager.

End-of-Lease Dispositions

The two most common occurrences that confront an asset manager in the end-of-lease scenario are:

- a) the lessee's desire to purchase the equipment (either for cash or short term financing) and;
- b) the return of the equipment, compelling a sale of the asset to a third party.

In the first scenario, the key element that points the appraiser in the proper direction is the purchase option language within the lease that defines the definition of value under which the lessee can buy the equipment. In the early days of leasing, this contract clause was very broadly written and typically stated the premise as "Fair Market Value" with minimal verbiage to further define and classify it. This would normally lead to the sale being negotiated on an "as-is, where-is" basis and the appraisal being completed on a cost and/or market approach, with no benefit for "Installed" or "In-Use" value.

Over the past several years, however, as both lessors and lessees have become increasingly more educated and experienced, purchase option language has been strengthened to include in-place or in continued-use language, especially where a significant portion of the lease financing includes soft costs, such as installation, training and engineering. This is prevalent in most manufacturing equipment transactions, where the assets require these additional capitalized investments to get up and running.

As of result of this expanded language, the appraiser can provide a valuation methodology that incorporates a stricter definition and can potentially utilize the income approach to the appraisal. As noted earlier, in the case of a facility type lease, the income approach would almost certainly be employed so long as the financial data was available for analysis. Assuming the lessee's business was operating at a profitable level, this approach will normally produce a value at or above the market and cost methods. This approach may also be weighted more heavily than the others in conjunction with the supporting purchase option language in the lease.

The second scenario involves a number of different variables when the lessee is faced with the return of the equipment and the inevitable task of selling assets in the secondary market place. Two of the issues to discuss under this scenario are the cost and market approach methodologies and the conversion of fair market value into liquidation value.

When the subject equipment being appraised is found to have a limited resale market for reasons discussed earlier, or if there has been no recent comparable resale activity to rely upon, the appraiser is compelled to weigh more heavily on the cost approach method. This presents a challenge when appraisers are asked to provide orderly and/or forced liquidation values, knowing the equipment has a limited re-sale market.

When comparable sales are available in the marketplace, the appraiser can make the proper assessments and adjustments that will reflect these sales into a proper format, and arrive at an estimate of liquidation value for the subject equipment. However, when the appraiser is compelled to utilize the cost approach, they do not have this data as a resource, and, therefore, must determine a reasonable method to establish liquidation values.

Keep in mind that the cost approach method, when completed, will provide the appraiser with a fair market value estimate. This value, by definition, assumes a willing buyer is located and the seller is under no compulsion to sell. A liquidation value premise is quite different in that the seller has compulsion to sell and a limited time frame is required to liquidate the asset.

When appraising equipment with a limited re-sale market, two of the resources that should be relied upon for data and opinions are the original equipment manufacturer (OEM) and the specific vendor. These contacts may be able to provide some level of comfort as to their ability to re-market and provide support services to a lessor/owner should the equipment be placed in the secondary market. The appraiser must form opinions based in part, on this kind of information, and must ultimately determine a reasonable downward adjustment from fair market value to liquidation value.

When the appraiser is compelled to rely more heavily on the cost approach method for determining orderly or forced liquidation values, the equipment manager should make a specific note that the lack of comparable sales data available to the appraiser will create a more risky environment in which to sell the equipment. If a legitimate purchaser is not found in the marketplace, the ability to realize the equipment's value from an actual sale will be limited.

Bankruptcies & Repossessions

Many of these same issues will arise when working through a bankruptcy or a less involved default scenario. The most important issue to uncover is the potential for a third party purchaser to be aware of the situation and have an interest in buying the assets or possibly the entire business. These third parties will likely attempt to buy the equipment for a liquidation value given their assumed leverage in the acquisition. In the case of a manufacturing facility, where the assets will remain in place, it is important to establish value on a Fair Market Installed or In Continued-Use basis, regardless of the implied compulsion issue. This will open up the potential for utilizing all three approaches to value, and provide the best chance of optimizing the outcome of the sale for the Lessor.

The third party buyers will bring in their own appraisers who will attempt to support an orderly or even forced liquidation premise, which will need to be contested. Once the value definition is settled, the ultimate sale can be negotiated from two much closer appraisal opinions.

In summary, the appraiser's goal when working with a leasing equipment manager is to provide the most appropriate, realistic valuation estimates using all data available for analysis, and understanding their specific needs and situation. When all three approaches to value can be utilized, the outcome is generally more supportable and beneficial to the Lessor. When only one or two of the approaches can be used, it is important that both parties understand the reasons why; and how the appraisal analysis can be best used when ultimately reselling the equipment.