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Quantifying a Loss on a Business Expropriation or a Permanent Impairment of Value Relating to a Public Work

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This paper will review key aspects of how to quantify the loss or permanent impairment of a business. Properties that do not involve a business are not considered in this presentation. The business valuator's purpose for quantifying a loss is to establish a price to appropriately compensate a claimant, either for the loss of a business or a permanent decline in the value of a business.

Compensation should be measured as either the value of the business (expropriation) or the decrease in the value of the business (permanent decline). The going concern market value of the total assets of the business are valued. This means all assets; real, personal and intangible, will be valued. This is appropriate whenever the highest and best use of the land underlying a business is the business operation; a good example of this is a hotel. The owner of a business whose business property has been expropriated or whose business has experienced a permanent decline will not be adequately compensated unless market value considers the contribution of real, personal and intangible components of the business operation.

Compensation will only be awarded if two criteria are met. First, it must be shown that the defendant is liable for damages. For this paper we will assume this is the case. Our claimant has won the necessary legal arguments and it has been established that the defendant has either expropriated a business or implemented a public work that has the potential to lessen the value of the claimant's business. The second criteria is to establish that the expropriation or public work has caused the loss. The business valuator will likely become involved at this stage because the analysis necessary to quantify the loss will show why the loss arose.

In this paper, my intent is to illustrate the process for "determining how the loss relates to the Defendant's actions" in a later section, using that heading. I will also review a number of valuation issues that require consideration in every business valuation, rather than provide an exhaustive analysis for how business valuators determine price or compensation.

Relevant Legislation (Alberta)

The first step in quantifying a loss is to understand any legislation that will have an on the methodology used in the loss determination.

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Expropriation Act

The *Expropriation Act* outlines what it describes as the Principles of Compensation in Sections 41 to 58. Sections 42, 43, 53 and 54 are pertinent to the topic of this paper and especially relevant to business owners. These sections declare the owner of an expropriated property is entitled to compensation for any economic benefit the owner was receiving from the property; including any goodwill of a business operating on the property that will be lost as a result of the expropriation, and any business losses incurred as a result of the relocation of an expropriated business.

Municipal Government Act

The following sections outline the basis for compensation under the *Municipal Government Act*.("MGA")

Section 534(1) *"A person having an interest in land that is adjacent to land on which a municipality has constructed or erected a public work or structure is entitled to compensation from the municipality for loss or the permanent lessening of use of that person's land caused by the public work or structure."*

Section 534(5*) "The amount payable as compensation under this section may not exceed the amount of the difference between:*
(a) the appraised value of the claimant's land prior to the construction or erection of the public work or structure, and
(b) the appraised value of the claimant's land after the construction or erection of the public work or structure, together with an amount of not more than 10% of the amount of the difference."

I interpret these sections to mean compensation is due to a landowner, if he is adjacent to a public work that has been constructed by a municipality, and the public work has caused a loss or permanent decrease in the value of his land. Compensation for this loss is the difference between the appraised value (market value) of the land before and after construction of the public work.

I believe that the intended meaning of "appraised value" is that the property will be valued at market value. There are numerous definitions of market value, all with a generally similar meaning. The Dictionary of Real Estate Appraisal Fourth Edition outlines five definitions.[2] The *Expropriation Act*, R.S.A. 2000, Chapter E-13 defines market value in Section 41 as, "the amount the land might be expected to realize if sold in the open market by a willing seller to a willing buyer". The *Expropriation Act* legal definition, while it overrides Appraisal Institute definitions for the purpose of that Act, is congruent with the meaning of those two documents. The MGA allows more latitude in interpreting the meaning of appraised value.

[2] Appraisal Institute, p177-178.

A useful guide for the term "appraised value" in Section 534 of the MGA is the market value definition used in property appraisals. Appraisal Institute of Canada defines market value as:

> *"The most probable price which a property should bring in a competitive and open market under all conditions required to a fair sale, the buyer and seller each acting prudently and knowledgably, and assuming that the price is not affected by undue stimulus."*

If you are not conversant with those sections of the MGA and the *Expropriation Act* and are involved in an expropriation or a section 534 matter, it is advisable that you review your understanding of these sections and their impact on your property with a lawyer who specializes in these matters. As a practical matter, particularly if you are the business valuator, your lawyer will appreciate it if you are familiar with the legislation prior to discussing the details with him. In all likelihood, this will also lead to lower costs.

Valuation Issues

The business valuator will be faced with valuation issues that are either absent or have a different significance when the loss is property that doesn't include an operating business.

1. Date of valuation.

Business valuations establish a market value at a point in time. This concept is applied by restricting the valuator to knowledge that an informed buyer or seller would have at the valuation date. Evidence described as *post facto* is not to be used in the determination of market value.

The principle has been extended by courts and judicial tribunals to allow the valuator to consider information subsequent to the valuation date, but only for the purpose of testing a trend that has been identified at the valuation date. Financial and economic information available after the valuation date should not have a direct impact on the valuation. As an example, the Alberta Municipal Government Board ("MGB") recently confirmed this principle with Board Order MGB 073/04, which rescinded Board Order MGB 168/03 because the earlier Board applied *post facto* data in arriving at their determination of market value.

Restricting the use of *post facto* data to testing a trend predicted by the business or valuator at the date of the valuation should not be interpreted to mean that the valuator has no interest in the future. The very essence of market value is establishing the present value of estimated future benefits that accrue to the owner. Market value is a forward looking concept. The business valuator must apply one or more valuation approaches that best capture future expectations.

This may mean using historic information when future focused information that could be developed by management (forecasts, budgets, business plans) is not available. Historic results would then be the best available predictor of expected future results. The valuator will still look to the future; he will want to estimate expected future growth and then take that into account in his capitalization rate. It is appropriate to check the reasonableness of his growth projections by comparison to future results. The reverse is not true. The valuator does not develop growth rates by benchmarking future results at the valuation date. Rather, the valuator would project growth rates by discussion with management, review of markets and other factors.

Two dates are relevant for compensation under Section 534 of the MGA.

(a) **Value before**. The first date can be at a point in time immediately prior to construction or at some earlier date. The date should be sufficiently prior to construction so that it won't be influenced by the prospect of construction. This can be illustrated by considering the recent Land Compensation Board case involving the Sands Motor Hotel ("Sands"). The Sands squared off with the City of Edmonton, asking for damages pursuant to section 534 of the MGA, arising from the construction of public works between April 1993 and October 1995 adjacent to the property.[3] The parties had agreed to April 1, 1993 as the pre-construction valuation date.

In retrospect,, as an expert advisor for the Sands Motor Hotel , it may have been advisable for the Claimant to have asked for an earlier date that would not have the potential for being impacted by pre-construction preparation. Financial trends suggest something was having a negative impact on financial results in April. Sands liquor store revenues (its major profit center) rose in March 1993 and dropped by a greater amount in April 1993. The drop likely was partly due to new competition but not entirely due to that source as the City's experts suggested. Other factors could have affected sales such as weather, restricted access or inventory shortages. Choosing an earlier date that was more clearly removed from construction would have eliminated any bias by either party that including April with its pre-construction activity would have imparted.

(b) **Value after**. The value after date can be either close to the completion of the public works or removed from that date. The argument for a later date is that it helps establish that there has been a permanent lessening (City argument in Sands)[4]. The argument for a date close to completion of construction, allows an expert to isolate what caused the change in value between the two dates and attribute the change to the public work.

[3] *The Sands Motor Hotel Ltd. and the City of Edmonton,* Land Compensation Board, Board Order 429, August 4, 2004

[4] Ibid. at p13.

In my view, extending the valuation date introduces numerous variables, each one potentially impacting value. The Board's determination in the Sands was, "In the Board's opinion, a valuation date of December 31, 1995, nearly two months after the completion of construction, is sufficient period of time to permit a proper and fair assessment of the impact of the works on the value of the property."[5] This was in contrast to the City's choice of a 2002 valuation date, which the Board found, "to be too remote"[6]. The Board that heard a previous case cited in the Sands appeal, Spoletini v. City of Calgary. On that occasion, the Board stated "the time period should be no longer than is necessary to establish such impact, because with the affluxion of time, the valuation becomes more difficult to make"[7].

2. Commercial versus Personal Goodwill

Businesses that are going concerns usually have an intangible asset called goodwill. Goodwill is defined in International Glossary of Business Valuation Terms,[8] to be, "that intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified." The Dictionary of Real Estate Appraisal Fourth Edition, adds to the Glossary's goodwill definition the following words, "…and/or valued but that generate economic benefits."[9] (my emphasis) In my view this is a useful enhancement of the Glossary's definition. It clarifies that the intangible must add economic value to be of interest to a valuator.

Goodwill is generally calculated as the excess, if any, of the going concern value over the net tangible asset value of the business. In other words, if you have a business that has a capitalized cash flow of $1,000,000 and net tangible assets of $800,000, it also has goodwill of $200,000. The question of concern to the valuator is whether the goodwill is transferable in a sale. Goodwill described as commercial goodwill is transferable and has value while personal goodwill is not transferable and would not be attributed value by a willing and knowledgeable purchaser. Personal goodwill, as suggested by its name, attaches to a person(s) and is independent of the business. It implies that if the person leaves the business, that the value of the business will decrease because the person has taken expertise, relationships, knowledge, etc. that has contributed to the $1,000,000 cash flow.

[5] Ibid. at p15.
[6] Ibid. at p14.
[7] Ibid. at p14.
[8] June 2001, Jointly published by: American Institute of Certified Public Accountants, American Society of Appraisers, Canadian Institute of Chartered Business Valuators, National Association of Certified Valuation Analysts and The Institute of Business Appraisers.
[9] Published by Appraisal Institute, Chicago, 2002 at p128.

The level of personal goodwill is easy to measure after the fact. If capitalized cash flow drops to $900,000 after the departure, all other things being equal, this suggests a personal goodwill component of $100,000. Valuators must determine personal goodwill at a point in time and before knowledge of a departure. This is done by considering whether any individuals are key to the success of a business and whether the business has made efforts to convert the goodwill to an enduring asset (commercial goodwill). Creating commercial goodwill includes steps such as ensuring that a non-compete clause and a succession plan are in place, documenting processes, procedures and contact lists and generally converting a key person's knowledge and contacts to information that is available to the business but not to competitors.

There may be situations when the claimant feels that there should be compensation for the loss of personal goodwill. The Claimant's first hurdle is to fit within the limits of the legislation. The *Expropriation Act* states that compensation is available for the loss of goodwill of a business. Is personal goodwill, goodwill of a business? By its nature, it attaches to the person and as outlined above, it is usually separated from the business. Like Perdita Felicien, the Canadian hurdler, the first hurdle may end the search for (personal goodwill) gold. The second hurdle may be equally as difficult. The Claimant must show that there has been a loss of personal goodwill. Because personal goodwill attaches to the person, there would have to a compelling set of facts before proceeding with a loss calculation for personal goodwill.

3. Redundant assets

Redundant assets are those assets not required in the day-to-day operations of a company. In theory, redundant assets could be disposed of without adversely affecting the on-going operations of a company, with the net proceeds distributed to the shareholders. They are part of the value of the legal entity affected by the expropriation or permanent impairment but because they can be removed they typically are not included in the valuation.

If redundant assets are included and valued, for example a personal use airplane owned by a business, disposition costs and related tax costs must be considered. In particular, the disposition and tax costs that face the party affected by the expropriation must be compared to the disposition and tax costs the party would incur if it was a willing seller. The tax costs would take into account the tax attributes of the asset being sold including its net book value for tax purposes and original cost.

A business will also have assets that while not redundant to the operations of the business, are portable and can be removed before the business is shut down. Examples would include inventory, working capital and certain tools, equipment, furniture and fixtures. The business owner may not be able to obtain market value for assets that are removed from the business because the highest and best use as an operating asset will usually command a higher value than an asset acquired in a

liquidation. The owner should be compensated for the difference between the two values.

A special type of redundancy is a hidden redundancy. A hidden redundancy exists when an additional amount of notional long-term debt, viewed together with related interest expense being charged against the net income and cash flow of a company, would increase a company's value. The theory behind a hidden redundancy is that as debt is added to an operation, the return on equity increases as long as the cost of debt is lower than the rate of return required on equity. The debt that is added to the company replaces equity; this excess equity becomes a redundant asset to the operation. The objective is to create an optimal capital structure where debt is used to finance the operation up to a point where the cost of new debt would decrease the return on equity.

Determining the optimal capital structure is a subjective process. The additional risk premium required on equity as debt is added is difficult to quantify and therefore requires some judgment. We would consider industry standards with respect to total debt to equity ratios for companies operating in the same industry and similar size the business being valued by reference to statistics published by an organization such as Risk Management Association (RMA).

We would also review the asset coverage restriction. We would calculate the maximum possible borrowing for a business by analysing the leverage ratios available in the market for the various assets. The current assets, accounts receivable, and inventory (including work in process) could conservatively be leveraged to 50% of value. The machinery and equipment capital assets can typically be leveraged to 60-70% of the orderly liquidation value and real estate to 65-75%. The debt to equity ratio is recalculated after leveraging the business assets.

Finally, we would review the interest coverage restrictions. Interest coverage ratios indicate a business's ability to meet their interest obligations through their earnings from operations. There are a number of interest coverage measures. A frequently used interest coverage ratio is the earnings before interest and tax (EBIT) to interest expense ratio. The industry average EBIT to interest expense ratio for companies of a similar size are compared to the ratio for the business being valued.

The hidden redundancy is the lesser of the amount of debt that would be permitted at an optimal debt to equity ratio and the amount of debt that would be permitted by applying asset and interest coverage restrictions. The constraint will be different in each case, it may be limited by asset coverage or by a restriction related to interest coverage.

4. Valuing Shares or Assets

My first inclination in a business valuation is to determine the market value of the shares of the company that holds and operates the business. Valuing shares will capture the value of all of the assets owned by the company, net of any liabilities. A

share valuation will ensure that intangible assets are valued, not individually, but as part of the total market value of the shares.

The most frequently applied valuation approach in a business valuation, not involving a public company, is the income approach. Using this prospective valuation approach, the business valuator quantifies the present value of future benefits associated with share ownership. The estimated future benefits that accrue to a shareholder are discounted or capitalized at a rate appropriate for the risks associated with achieving those benefits. Common methods within this approach include: the discounted cash flow approach and the capitalized cash flow or capitalized earnings approach.

The income approach provides the market value for the business as a whole because the expected future income arises from contributions of all of the company's assets. In other words, a company invests in assets only because they expect a return from those assets. The market value of intangible assets (including assets that are not on the balance sheet) as well as the market value of personal and real property will be included as part of the share value of the company.

A business valuation does not require the market value to be allocated between assets. An allocation is only required for assets that are to be removed from the business and retained by the owner and/or redundant assets. If assets are removed that are required in the operation of the business, their value will reduce the market value of the remaining business. For example, if the Claimant is keeping inventory, the value of the inventory will be netted against the value of the business. If the assets being removed are redundant assets, then their value is considered separately and will not reduce the value of the business.

Valuing a business by valuing assets rather than shares can lead to an understated or overstated value of a business depending on the value ascribed to each asset. The value of a business taken as a whole is rarely the sum of the values of the individual assets. The major flaw in valuing assets (the asset approach) is that it is necessary to apply a build-up approach, describing and valuing each of the business assets in turn. The value of some assets can be missed or understated (usually intangible assets); other assets may be overvalued in terms of their contributory value(real and personal property).

The valuation problem that arises in valuing the real property of a business is determining what share of the business's cash flows can be attributed to the real property. For example, a hotel (Hotel A) may earn significant profits and be located next door to a similar hotel property (Hotel B) that earns half the profits of Hotel A. Does that mean that the real property owned by Hotel A is worth twice the real property owned by Hotel B? Logic would say no. Assets other than the value of the real property are contributing to the value of Hotel A. Those assets will include the value of the franchise, name, reservation and management systems, personal property assets, etc. The person valuing the real property of Hotel A may be inclined to overstate the market value of real property component of the business because of the difficulty in extracting the cash flows that are generated from assets other than

the real estate. It is also possible that the market value of Hotel B's real property is understated because that hotel's poor financial performance has been attributed to the real property when it relates to a negative intangible like poor management.

My view is that a business valuator should value shares as a preferred alternative to facing the valuation issues that arise when individual business assets need to be valued as a means of arriving at the value of a business.

Determining How the Loss Relates to the Defendant's Action

Determining the market value of the business will be of no help to the parties if the loss cannot be directly related to the actions of the Defendant. It is necessary to establish that the Defendant caused the loss before damages can be assessed.

The recent Sands case provides an interesting case study for this concept. The Sands Motor Hotel is located at the intersection of two major roads, Yellowhead Trail and Fort Road. This was a grade intersection until the City of Edmonton constructed a tight diamond interchange. The Claimant alleged that this public work caused a permanent impairment and a claim for damages was made under Section 534 of the MGA.

The first step was to establish whether there was a loss. The legislation mandates the process; for the Sands, this meant determining the market value of the business before and after the construction of the public work. This was done and the Claimant's experts determined that there was a substantial decline in market value, from a market value approximating $3.5 million before the public work to about $700,000 after. As well, the highest and best use changed from a hotel to a redevelopment property. The Defendant, "estimated the pre-construction market value as $920,000, which was also his value post-construction."[10] for the business or the improved property. The Defendant concluded that, "…pre-construction value was less than the value of the property as a redevelopment site."[11] In a like manner he concluded post-construction value was also less than the value of the property as a redevelopment site.

Even though the first step, determination of the size of the loss, may be in dispute it is still necessary for experts for both Claimant and Defendant to proceed with an analysis of what caused the loss, if any, in the event that a loss is established. As stated by the Land Compensation Board, "If the market value of the Claimant's lands decreased between the two dates, was the change in value caused by the construction of the public works?"[12] It is best to address this requirement fully and include all relevant evidence. In the Sands valuation we reviewed any external and internal factors that could cause a change (either increase or decline) in the Sands' profitability between the two valuation dates. We wanted to be as comprehensive as possible.

We felt that the only internal factor that could cause a swing in profitability would be a change in management. We identified that the ownership group, the director and the hotel

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[10] *The Sands Motor Hotel Ltd. and the City of Edmonton,* Land Compensation Board, Board Order 429, August 4, 2004 at p 27.
[11] Ibid at p 27.
[12] Ibid. at p18.

manager were the same throughout. An expert for the Defendant praised the quality of Sands management. There were no other obvious internal changes. For example, the hotel remained an independent operator throughout the period and an analysis showed that management continued to invest in repairs and maintenance.

Significant external factors were at play during the period in question. In order to properly address the impact of external factors it was important to understand that the Sands had a number of profit centers; hotel operations including rooms, restaurant and tavern operations as well as a separate beer/liquor store. The hotel operated as a truck stop and catered to the northeast Edmonton market, drawing most of its business from the Fort Road and Yellowhead Trail. The liquor store drew business from the same market. Both businesses relied on visibility and accessibility as key determinants of their success.

Among the external factors included in the review were:

> **Traffic**: The Board summarized my testimony as follows, “Traffic volumes were increasing between the two dates. He concluded that in the absence of the public works construction, the increase in traffic should have been a positive influence on the market value of the Claimant’s property.”
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> **Changes in liquor laws**: The Sands was Edmonton’s first freestanding cold beer store when it opened in 1989. All liquor sales were privatized on September 2, 1993. The Sands took advantage of this by converting that day to a full service liquor store. The Claimant’s report compared the sales performance of the Sands to three other beer stores converted to liquor stores and noted that the other stores recovered their sales after a brief decline. The report concluded that privatization should not have significantly impacted the value of the Sands between the two valuation dates. The Board took exception to this aspect of the report, feeling that the opening of the Forum, Transit and Cromdale beer/liquor stores (nearby) should been addressed in the report and would have had a greater impact on the decline in Sands liquor store revenues than provided for in the Claimant’s report.
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> This is an example of how the Claimant’s report would have been improved if it had addressed potentially unfavourable information for the Claimant in the report rather than dealing with it outside the report (in rebuttal). As the Claimant’s expert on this matter, I was aware of the opening of these three stores and had considered their impact on the Sands but had not dealt with them directly in the report. I felt the impact would be minimal because the Sands primary trading area was traffic from the Yellowhead Trail, as well the choice of capitalization rate and maintainable cash flow provided for the effects of new competition. This evidence as well as other evidence that considered the impact of new competition[13], while not in my report, was introduced during the course of the Hearing.
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> Experts for the Defendant suggested that liquor store revenues would have declined to between 20% and 40% of 1991 revenues because of new competition.

[13] “The Board accepts Mr. McNally’s explanation that when competition is introduced there may be an initial decline, but eventually competitors will share the market. This did not happen in the Claimant’s case.” Ibid. at p 35.

The Defendant's reports were weakened because the Board noted that the reports did not contain an analysis of the market and any economic analysis did not directly address the Sands' market. We were able to counter the Defendant's forecast decline with information showing that the Parkdale Liquor store opened across the street from the Cromdale in 1996. Twelve months after the Parkdale opened, the Cromdale's sales had declined by only 14.6%. This illustrates that specific financial information and analysis is more effective than general observations and opinions.

The Defendant also relied on evidence based on a Molson's analysis of the number of cases of beer. The Board concluded, "It does not address all beer sales, but only certain brands and does not capture the sale of beer in quantities of less than a dozen."[14] They also noted that the evidence did not address the sale of other liquor products. The Claimant initially supplied this evidence to our team, expecting us to use it in the claim. We decided not to rely on the evidence, not because it was unfavourable, but for the reasons identified by the Board.

The Board applied a 20% reduction in revenues for the effect of the Cromdale and Transit and concluded that the loss of accessibility and visibility caused by the public works were the cause of any further reduction.

Changes in gambling laws: Video lottery machines ("VLTs") were introduced to hotels in 1992. We observed that this would have had a positive impact on the Sands operations and adjusted expected financial results accordingly.

Economy: The Claimant's experts felt that the economy improved between the valuation dates while the Defendant held the view that the economy, "was at a low point in 1995"[15]. They reached different conclusions because they placed weight on different data. In my view economic data has to be considered in the context of the business being valued. The economic indicators should be used to measure some aspect of the business being valued. For example, average room rates and occupancy rates for hotels in Edmonton were shown to be increasing between 1993 and 1995. The Board concluded that the Defendant's, " indicators are not relevant to the Claimant's business."[16]

Deferred maintenance: Experts for the Defendant adopted the position that maintenance had been deferred and the hotel was, "old and tired"[17] and this was a reason for the decline in room revenues between 1993 and 1995. They cited a hotel room upgrade in 1999 and how the Sands had its best room revenues in 1999. The Board concluded that this expert's, "opinions were not well researched."[18] The Defendant, "was unaware that the improvement in room

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[14] Ibid. at p39.
[15] Ibid. at p37.
[16] Ibid at p 38
[17] Ibid. at p24.
[18] Ibid. at p40.

> revenues after 1999, was the result of an exceptional contract with Shell for 40 of its 52 rooms. When the contract expired in 2002 room revenues declined."[19]

We felt that we had reviewed all external and internal factors that could be the cause of the decrease in the Sands' profitability between 1993 and 1995. We adjusted our maintainable cash flow to take into account any factor that we concluded would have either a positive or negative impact on financial results. Ignoring the impact of any significant factor would weaken the report's conclusions. This highlights the importance for the business valuator to maintain an independent perspective and thoroughly investigate and consider all facts relevant to the business.

Conclusion

Both the *Expropriation* Act and *Municipal Government Act* (section 534) provide for compensation to owners. A business valuation is the best way of determining compensation when either an expropriation or a public work causing a permanent impairment in market value has an impact on that business. The business valuation when structured as a valuation of the ownership interest (usually shares) will provide a market value for all assets, net of any liabilities. A business valuation, as an alternative to valuing individual assets, assures the Claimant that he will be compensated for the full value of his property. Caution should be exercised when valuing individual assets to ensure all components are identified and valued properly.

The business valuator faces numerous valuation issues when valuing a business, some very specific to individual cases. Issues relating to commercial versus personal goodwill and redundant assets among others need to be addressed. Central to the analysis is the date of the valuation and what is being valued. The valuator needs a full understanding of the business and needs to undertake a complete review of the environment in which the business operates. This is required to forecast the expected benefits the operation will enjoy.

The business valuator's job is not done when the business valuation is complete, if the valuation is for either an expropriation or a permanent impairment of value relating to a public work. The business valuator will be a central part of the analysis to determine whether the decrease in the value of the business relates to the Defendant's actions. As part of a normal valuation he will have considered internal and external factors that will have an impact on the business. He can use that information to identify and justify conclusions of who caused what.

I would like to thank my two associates, Gordon McKay and Chris Perret, for their invaluable assistance in the preparation of this paper.

[19] Ibid. at p40.