WHAT ABOUT THE WORD "COMPARABLE" DO YOU NOT UNDERSTAND?

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THREE APPROACHES TO VALUE

In arriving at an opinion of market value, appraisers are to consider three approaches to value.

- Cost Approach
- Sales Comparison Approach
- Capitalization of Income Approach

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THREE APPROACHES TO VALUE

- Theoretically, each is a method or technique based on data **presumably extracted from the market**.
- Indications of value from each approach evaluated, reconciled, and weighted to reach a final opinion of market value.

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COST APPROACH

- There are substantial differences of opinion as to whether this is an appropriate approach for valuing a mineral property.

- Not relevant to issue of comparability.

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SALES COMPARISON APPROACH

- Somewhat more difficult to use for mineral properties than for real estate.
- Can be used with appropriate reconciliatory techniques.

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SALES COMPARISON APPROACH

- One obvious difference – typically expressed as price per unit rather than price per acre.
- Example - $ per ton or $ per ton and grade

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SALES COMPARISON APPROACH

Use of this approach appears simple enough.

- ❖Identify potential comparables.
- ❖Establish volume (and grade) of mineral deposit.
- ❖Appropriately attribute purchase price on unit basis for comparison with subject property.

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SALES COMPARISON APPROACH

Important to recognize , however that the existence of a lease on a property creates two distinct estates:

- The Leased Fee Estate, which is the property owner's interest

  and

- The Leasehold Estate, which is the mine operator's interest.

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SALES COMPARISON APPROACH

- Should be able to agree that the value of these two estates in the same property can be significantly different.

- It thus follows that a purchaser could be expected to pay more for one estate than for the other.

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SALES COMPARISON APPROACH

- Important to recognize that the absence of a lease does not mean a property would not be purchased in anticipation of leasing it.

- Such a buyer is a passive investor, as opposed to a buyer that intends to be the operator of the property.

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SALES COMPARISON APPROACH

The following questions are relevant in considering sales as potential comparables.

- Was the property producing?
- Would the Hypothetical Buyer be acquiring property encumbered by one or more leases or one for which no mineral leases in effect?
- Would the Hypothetical Buyer be a passive investor seeking royalty income or a producer seeking operating income?

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SALES COMPARISON APPROACH

If subject property producing, whether leased or owned by the producer, it is common to allocate purchase price amongst asset classes.

- Plant, machinery, and equipment
- Improvements
- Reserve
- Real estate

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SALES COMPARISON APPROACH

The allocation process is fraught with problems, but that is not the subject of this discussion.

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SALES COMPARISON APPROACH

Such an allocation then raises the following questions .

- Were the reserves for the comparable leased or owned?
- How does this compare to the subject property?

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SALES COMPARISON APPROACH

- If the mineral interests are leased on one property and owned on the other, wouldn't this be expected to affect the purchase price?
- If the reserves for the comparable were leased and in production and the property was sold to other than the operator to the property, would the purchase price be expected to differ from the purchase price by an operator?

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SALES COMPARISON APPROACH

In instances in which the Subject Property was not producing, the following questions arise, which compound each other.

- Was the purchaser in the sale being considered as a comparable a passive investor purchasing the property to receive royalty income or an operator purchasing the property for development and receipt of operating revenue?

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SALES COMPARISON APPROACH

- In your Appraisal, who do you consider the Hypothetical Buyer to be, a passive investor seeking royalty income or a producer seeking operating income?
- This decision can involve a variety of factors arising from the intended use of the appraisal.

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CAPITALIZATION OF INCOME APPROACH

- One does not necessarily equate the Sales Comparison Approach with selection of a discount rate for use in the Capitalization of Income Approach.
- Comparability becomes a significant issue however, when the appraiser goes to the market as a source of discount rates.

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CAPITALIZATION OF INCOME APPROACH

As discussed previously, there are two categories of potential purchasers.

- A passive investor seeking royalty income.
- A producer seeking operating income.

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CAPITALIZATION OF INCOME APPROACH

As a general statement, it follows that the discount rate used in each circumstance can be expected to differ, at a minimum because of differences in the capital outlay required and the business risk involved.

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CAPITALIZATION OF INCOME APPROACH

Accordingly, one would not query a landholding company about what discount rate it uses and an operating company about what discount rate it uses and expect these to represent comparable situations.

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CAPITALIZATION OF INCOME APPROACH

The requirements for comparability discussed earlier are thus relevant to the selection of a discount rate when market data are used.

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EXAMPLE NO. 1

- Industrial sand-bearing property being taken in condemnation.
- Mining lease on a portion.
- Property not producing.
- No plan to mine property

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EXAMPLE NO. 1

- Appraiser used three sales in determining an indication of value for reserves.
- Sale No. 1 and Sale No. 2 involved purchase of a producing company by a producing company.
- Imputed value of reserves for each sale derived by allocating purchase price to various asset classes.

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EXAMPLE NO. 1

Key Issues -

- Values in the two sales were derived from a producing property, with the Subject Property being undeveloped.

  Conclusion: Not comparable

- Values in the two sales were based on an operating income, with the value of the condemned property to be determined based on receipt of royalty income.

  Conclusion: Not comparable

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EXAMPLE NO. 1

- Sale No. 3 involved purchase of an undeveloped property by a potential developer and producer.
- Selling price equated to be an indication of value of the reserves.

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EXAMPLE NO. 1

Key Issue

- Value in the sale was derived from the potential developer, which would receive operating income, with the value of the condemned property to be determined based on the receipt of royalty income.

Conclusion: Not comparable

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EXAMPLE NO. 2

- Same condemnation proceeding as Example No. 1.
- Appraiser was establishing a discount rate for use in Capitalization of Income Approach.
- Appraiser used discount rates from three formal preliminary economic assessments prepared for three industrial sand projects.

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CAPITALIZATION OF INCOME APPROACH

Key Issue

- The discount rates used in the three PEAs were for use by the developer and operator of a project with the discount rate to be used for the condemned property more appropriately being that used by a passive investor.

Conclusion: Not comparable

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SUMMARY AND CONCLUSIONS

- There are multiple facets to the concept of comparability.
- The use of the Sales Comparison methodology requires a thorough analysis of comparability issues.
- The misuse of even one facet negates the concept of comparability.

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WORDS YOU CAN LIVE BY

Value is a perception and, like beauty, is in the eye of the beholder.

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