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The valuation of fast food outlets in Australia: methodology, analysis and reliability

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Abstract

Fast food outlets are a significant sub sector of the Hospitality and Tourism Property Market and a specialized form of business. This form of hospitality outlet has experienced significant growth and change in the last 20 years. Their value as an asset is therefore of significant interest to many involved in the tourism and hospitality industry, not least fast food operators or potential operators and their financiers. However, little attention has been given in professional and academic literature to valuation methodology, the analysis of the major components of asset value, and the underlying factors which influence asset value. As such the reliability of the valuation process could justifiably be questioned.

This paper sets out a working definition of a fast food outlet. It investigates the major determinants of value with respect to asset value and examines the accepted methods of valuation of fast food outlets in Australia as well as establishing the methods most commonly used. It clarifies the major components of asset value and examines to what extent these have changed with the changing business environment. In particular it isolates the role of Goodwill in assessing Going Concern Value. Sources of data include a comprehensive literature review and personal interviews with professionals involved in the valuation process. The paper concludes that an efficient valuation process requires that fast food outlets be considered as both a real estate and business investment. The contribution of both tangible and intangible assets to the value of the asset must be identified.

1. Introduction

Changes in lifestyles and demographics in many of the advanced economies has resulted in ever increasing demand for fast food restaurants over the last 20 years. Australia is not an exception to this trend. This increase in demand has been stimulated by increasing disposable income and households which, for various reasons, have less and less time or at least a perceived reduction of time in which to prepare meals at home.

Although there are signs of maturity in the fast food market and therefore a slowing of previous historical rates of growth, the fast food industry is still planning for additional growth. For example, "McDonalds", perhaps the best known fast food operation in the world was reported to be planning for an increase of 200-300 outlets from its present 570 outlets in Australia by the year 2000. (Business Review Weekly, 18/10/96) Many of these new outlets will be cut down versions in petrol stations, K Mart Stores and city outlets called "MacCafes". No doubt this same strategic move to increase market share in a market that is already highly competitive will be to a greater or less extent followed by many of McDonalds` competitors.

The advent of franchising has also had a significant effect on the fast food restaurant industry in recent times. The most recent recently available statistics show that Australia`s 555 franchise systems and 26,000 franchisees generate total turnover of more than $40 billion and employ 279,000 people (more recent estimates are 700 franchise systems with a turnover of more than $50 billion). (BRW 30/6/97)
Clearly the importance of the fast food sector cannot be understated, being a specialised sub sector of the hospitality property market. It is argued however that the property professional involved in this area needs to understand the 'business' of fast food as it is the 'business' that determines the level of the cash flow. The going concern value of any hospitality property is as much influenced by competitive position in terms of its business as it is with real estate parameters and the real estate component of such a business cannot be valued without some knowledge of the business component.

Unfortunately, it would appear that at present few practicing Valuers in Australia feel inclined or suitably qualified to become involved in the valuation of businesses. This is supported by some related research in this field where members of the Australian Institute of Valuers and Land Economists were surveyed regarding the valuation of businesses. The majority of respondents indicated that they were not aware of the methodology for valuing business goodwill and that there was a need for a greater awareness of the valuation of intangible assets. Also, the majority indicated that the Property Valuer should be involved with this type of valuation.

2. Purpose

The purpose of this paper therefore is to provide a greater awareness of the valuation of hospitality businesses such as fast food restaurants. Surprisingly, there is little written on the methodology involved in the valuation of hospitality property and even less relating to the valuation of fast food restaurants in Australia. An analytical framework is required which embraces both the tangible and intangible components of fast food facilities. For even if it is accepted that the value of the intangible asset i.e. goodwill is to be assessed by the accountant, the property manager and valuer is still involved in their valuation and management as going concerns. As such an understanding of the role of the intangible component is still considered essential if advice is to be reliable.

More specifically, the aim of this paper is to develop an analytical framework within which valuation methods of hospitality property such as fast food restaurants can be critically examined and explained.

A comprehensive literature review has been undertaken to synthesize and identify issues in order that an analytical framework could be established for valuation methodology. Valuation methods were then examined through the research of the valuation literature and in depth interviews with key players in the industry.

3. Analytical Framework

Valuation methods are obviously not applied in a vacuum, i.e. the variables in the valuation model represent value determinants which are dynamic and judgment is made in adjusting these variables to reflect changes in these determinants. Hence a brief discussion of these value determinants is provided as a foundation to the analytical framework.
The scheme of this paper in terms of the analytical framework and examination of valuation methodology is represented by Figure 1 below.

**Figure 1:**

**VALUATION OF FAST FOOD RESTAURANTS; ANALYSIS, METHOD AND PRACTICE**

Fast food restaurants, as with all other businesses can be segmented into two value components, namely tangible and intangible. These two components can be valued separately and therefore justify their own valuation methods, although they can also be combined to provide a going concern valuation of the total asset. This paper analyses the intangible and tangible components first in order that their contribution to going concern value can be appreciated. This process also assists in clarifying how the two components are interrelated. Before examining these components in more detail, however, a definition of fast food restaurants must be stated and is set out below.

**4. Definition**

For the purpose of this paper fast food restaurants are defined as facilities where food is served to a patron at a self service counter or through a drive through window. The food may be prepared in advance or it may be cooked to order. The term is not confined to large corporate food service entities.

Fast food restaurants generally conform to the following criteria:
- The basic menu items are tasty, generally appeal to everyone and offend as few as possible;
- These menu items also have a good inherent profit margin;
- The ingredients for the menu items are easy to obtain;
- The menu items are simple to prepare by lower skilled chefs. (Pillsbury, 1990)
In The Dictionary of American Food and Drink, John Mariani described Fast Food as “food dispensed quickly at inexpensive restaurants where only a few items are sold, often precooked or prepacked. These items include hamburgers, hot dogs, french fries, pizza, milk shakes, soda and ice cream. As an adjective, the term was traced back to 1969, although as a noun it must precede that date by a few years. Today the term fast food is often synonymous with junk food, which also appeared in the 1960’s and 1970’s but which includes store-bought items...considered to have little nutritional value or to contain “empty calories” “.

5. Value Determinants

The first step in providing any framework for the valuation of fast food restaurants is to outline the overall environment within which the typical firm is operating. The property professional therefore must not only consider the performance of the individual company but also understand the fast food industry itself. At the firm level, the value determinants can be summarised as:-

5.1 Management

Good management in fast food operations involves elements of quality control, high levels of teamwork and management strategies, which increase the average spending of customers. A good manager will have a high degree of quality control over both food quality and the running of the whole establishment. In order to ensure the smooth running of the restaurant the manager needs the experience to choose good staff that can work as a team and achieve common organisational goals. In summary, good management requires specialised skills in business marketing and promotion, as well as financial and human resource management. (Saunders, 1994, p.23)

5.2 Franchise-Franchisee Relationship

If the fast food operation is franchised then a major determinant of value is the quality of the franchise. For example, Franchisers set operating standards through setting procedural guidelines, to provide uniformity between stores. Consumers, especially those, who are travelling, feel a type of reassurance about the knowledge that no matter where they are the MacDonald's or whatever around the corner will be the same and serve the same product as their local store. This familiarity increases sales as customers feel reassured by the consistency of product (Saunders, 1994, p.24).

This view is confirmed by American consumer and attitude behaviour studies which concluded that “The majority of respondents from all user groups expect the food at fast food restaurants to be consistent from one visit to the next. (National Restaurant Association Research and Information Service Dept, 1983, p.61)

Aspects of franchise agreements such as quality of operating standards, service, cleanliness etc. (usually determined by manuals which outline how tasks should be carried out) then have a significant impact on cash flow, and hence value.

5.3 The Physical Nature of the Tangible Aspects of the the Business

5.3.1 Equipment, Plant and Machinery

Fast food restaurants consist of a building within which there will be areas for seating, food preparation, serving, office, and bathroom facilities. The equipment in each area will vary from one style of operation to the next.
Typically, equipment in fast food restaurants will consist of:-

Seating - chairs and tables will be of a design that will encourage a high customer turnover, being slightly uncomfortable in order to limit the amount of time each patron spends in the seating area, so as to increase turnover. The décor in the area will be of a style which will encourage hunger as well as turnover - colour being a useful tool in achieving this effect.

Food Preparation Equipment - most equipment and benches will be constructed of stainless steel due to its ease of cleaning and durability. Typical equipment found in 'hamburger' type fast food outlets would be deep fryers, grills, cold rooms, microwave ovens, assembly benches, refrigerators and freezers, drink dispensers.

Office - general office equipment will facilitate the running of the restaurant and would be standard to any office, except computer software which might be specific to the organisation.

Equipment lists in general then will vary from restaurant to restaurant and is therefore highly specialised and subject to functional obslescence as far as 'open market value' is concerned. (Saunders 1994 p25)

5.3.2 Land and Buildings

Fast food restaurants are obviously 'specialist' properties often specifically designed and tailored for major brand identification. The value of the actual building is largely determined by its functional adequacy. In particular, size is of importance in terms of its ability to satisfy customer demand within its catchment area and perform efficiently.

If the restaurant is too large for its catchment area it will run inefficiently due to the large amounts of idle space which still have to be generating a profit. Conversely, if the restaurant is too small for the catchment area, the restaurant will be excluding itself from valuable turnover. These same principles of functional adequacy also apply to car parking facilities.

Finally, visibility and exposure of the land and buildings obviously has a crucial influence on value. For most types of fast food restaurants, the better the visibility the greater the opportunity to do business. (Saunders, 1994, p.26)

5.4 Legal Interest in Property

Finally, the nature of the legal interest in the property from which the business is operated ie. Freehold, leasehold and duration of lease, will have both a direct and significant interest on magnitude of value, whether valuing on a going concern basis or the intangible and tangible components separately.
6. **External Value Determinants**

6.1 Consumer Attitudes and Trends.

These are changing constantly and influenced by variables of age, income, lifestyle, household composition etc. In recent years, health factors have become an increasingly important influence and one which fast food operators have had to address in terms of image.

**Economic (ie. The Effect of Competition)**

Both the entrance of new competitors in the catchment area and the entrance of new products being produced by competitors directly affect the value of fast food restaurants. Other economic factors that indirectly affect value are levels of interest rates within the economy and levels of unemployment within the catchment areas.

**Location Linkages**

Like all real estate, locational linkages with other complimentary land uses has a crucial influence in value. For fast food restaurants, these linkages are with its catchment population and in this sense, fast food restaurants can be classified by their locational and market criteria, eg. fast food stores located at major traffic arteries; in dense urban areas; at highway interchanges; within major malls and shopping centres; in University areas; hotel resort areas, etc. It is obviously preferable to establish locations which enjoy the benefits of more than one of these locational/market criteria. Melaniphy suggests there are 11 site types that apply to the fast food industry and that most diverse fast food chains should enjoy at least 4 of the different locational criteria outlined by him. (Melaniphy, 1992)

The nature of these value determinants, then, must be identified and analysed at the commencement of the valuation process to determine their impact on the value of the intangible and tangible assets of fast food restaurants. These asset components are examined next as part of the analytical framework together with the valuation methodology that may be appropriate for their valuation.

7. **The Intangible Component**

The intangible component of a business is a complex subject. It is generally referred to as the goodwill component of a business. However, there is no doubt that the intangible component of a business has evolved in recent years to mean much more than the term “goodwill” was originally intended to represent. Other aspects of the intangible component might include intellectual property, trade names, customers lists etc., many of which may for example, fall within the scope of a franchisor/franchisee agreement in fast food restaurants.

This confusion over the meaning of the term intangible asset and its relationship to goodwill is illustrated in Figure 2 below. Whilst the actual difference between tangible and intangible is relatively clear the diagram highlights the fuzzy area of separate intangible assets. The legally identifiable intangible assets being separable are closer to the tangible end of the spectrum whilst other intangible assets are closer to goodwill in that they attach to and become part of the underlying business.
Figure 2: The Spectrum Of Intangible Assets

<table>
<thead>
<tr>
<th>Tangible</th>
<th>Separate Intangible</th>
<th>Goodwill</th>
</tr>
</thead>
<tbody>
<tr>
<td>Seperable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Not Seperable</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(Simmonds, 1995)

It appears that many valuers would include all the items within the intangible spectrum under the category of goodwill without differentiating between them.
Table 1 lists a large number of these intangible assets of which goodwill is only one.

<table>
<thead>
<tr>
<th>Intangible Assets Commonly Valued</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advertising Campaigns</td>
</tr>
<tr>
<td>Agreements</td>
</tr>
<tr>
<td>Airport gates and slots</td>
</tr>
<tr>
<td>Appraisal plants</td>
</tr>
<tr>
<td>Awards and judgements</td>
</tr>
<tr>
<td>Bank customers</td>
</tr>
<tr>
<td>Blueprints</td>
</tr>
<tr>
<td>Book libraries</td>
</tr>
<tr>
<td>Brand names</td>
</tr>
<tr>
<td>Broadcast licenses</td>
</tr>
<tr>
<td>Buy-sell agreements</td>
</tr>
<tr>
<td>Certificates of need</td>
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<tr>
<td>Chemical formulations</td>
</tr>
<tr>
<td>Claims</td>
</tr>
<tr>
<td>Computer software</td>
</tr>
<tr>
<td>Computerised databases</td>
</tr>
<tr>
<td>Contracts</td>
</tr>
<tr>
<td>Cooperative agreements</td>
</tr>
<tr>
<td>Copyrights</td>
</tr>
<tr>
<td>Credit information files</td>
</tr>
<tr>
<td>Customer contracts</td>
</tr>
<tr>
<td>Customer lists</td>
</tr>
<tr>
<td>Customer relationships</td>
</tr>
<tr>
<td>Designs</td>
</tr>
<tr>
<td>Development rights</td>
</tr>
<tr>
<td>Distribution networks</td>
</tr>
<tr>
<td>Distribution rights</td>
</tr>
<tr>
<td>Drilling rights</td>
</tr>
<tr>
<td>Easements</td>
</tr>
<tr>
<td>Employment contracts</td>
</tr>
<tr>
<td>Engineering drawings</td>
</tr>
<tr>
<td>Environmental rights</td>
</tr>
<tr>
<td>FCC licenses</td>
</tr>
<tr>
<td>Favourable financing</td>
</tr>
<tr>
<td>Favourable leasing</td>
</tr>
<tr>
<td>Film libraries</td>
</tr>
<tr>
<td>Food flavourings/ recipes</td>
</tr>
<tr>
<td>Franchise agreements</td>
</tr>
<tr>
<td>Franchise ordinances</td>
</tr>
</tbody>
</table>

There have been numerous attempts by various authors to establish a clear definition of goodwill.

Blackman (1992, p.110) stated "goodwill relates to things such as (1) physical assets (location); (2) excess profits on invested capital; (3) the kinds of things that generate continued patronage (reputation, special skills, name, quality) and has no existence if there are no excess profits or potential for same in the near future”.

Callard et al (1994, p.58) explained that “all the essential components of a business are contained, or implied, in the definition of ‘goodwill’: location, tenure, dependability, legality, skill, quality, material supply and profitability or ‘patronage’.
In Inland Revenue Commissioner vs. Muller & Co’s Margarine Ltd. (1901) A.C.217, Lord MacNaughten said:
“What is goodwill? It is a thing easy to describe, very difficult to define...” This is a significant statement as many writers recognise the relevance of this explanation of goodwill by referring directly to it (Adamson, 1986).

Further in the same case, Lord MacNaughten declared:
"Goodwill is the benefit and advantage of the good name, reputation and connection of a business. It is the attractive force which brings in custom. It is the one thing which distinguishes an old established business from a new business at its first start - goodwill is composed from a variety of elements. It differs in its composition in different trades and in different businesses in the same trade. One element may predominate here and another there."

A rough and ready but nonetheless useful test was also put forward by Lord Eldon in Cruttwell vs. Lye (1810) 17 Ves. Jun. 335 at 336: what is 'the probability that the old customers will resort to the old place?' (Whipple, 1986).

A business can only be said to have goodwill if it has an expectation of future maintainable profits sufficient to justify it (Tonkin and Pescod, 1984). It would seem that goodwill is the benefit from customers returning to the same business, although this benefit is usually measured in the form of profits.

The intangible component of a business for the purpose of this paper is represented by the term "business goodwill".

Business (or "commercial") goodwill can be generally described as the ability of the business to retain customers in the future. It is generally recognised that commercial goodwill follows the business, can be transferred from one business to another, and can have material value, although the amount of its value is generally a function of the degree to which goodwill is sustainable and its likely effect on the earning capacity of the business (Horvath, 1990).

It is often perceived that business goodwill is the element that holds a business together. This viewpoint was emphasised in Trego vs. Hunt (1896) A.C.7, where Lord MacNaughten stated:
"Often it happens that the goodwill is the very sap and life of the business, without which the business would yield little or no fruit."

As such, intangible components such as trade names, intellectual property etc. which might form the basis of a franchise agreement, would fall within this definition of business goodwill. Hence, the value of the business goodwill for a fast food restaurant could be apportioned according to the nature of the franchise. The value of business goodwill then, is primarily based on the outlet’s capacity to earn a profit over and above an appropriate allowance for proprietor’s remuneration and a reasonable return which could be obtained elsewhere for investment of funds necessary to purchase the tangible assets of the business (Tonkin & Peascod, 1984). Such profits are often called “super profits” and are alternatively described as excess earnings due to the ability of the business to return income over and above the earnings required for the business to exist. Super Profit has also been defined as the amount of profit available after providing market rates of remuneration for all capital and labour employed in the conduct and management of business. (Gil Wright & Associates)
7.1 Valuation Methodology of Intangible Assets

There are a variety of approaches available for valuing the intangible assets, the majority of which can be categorised as Industry ‘Rules of Thumb’ or Accounting based methods. Industry based methods are commonly related to turnover and are considered more applicable to smaller businesses.

Accounting based methods such as the Capitalisation of Future Super-Profits or Discounted Cash Flow approach is the most widely adopted valuation approach supported in the literature. This approach considers the primary reason for the purchase/ownership of a business, which is to return profits and subsequently increase the investor’s financial wealth. It is based on the economic principles of anticipation and the expected risk/return investment relationships (Pratt, Reilly & Schweithes, 1996). This method requires the identification of all tangible assets and their valuation employed in the business at a going concern in-situ value.

The capitalisation of super-profits method consists of the following 3 stages:

Stage 1 -> assess the monetary value of the super-profits (or excess earnings).
Stage 2 -> identify an appropriate (market derived) capitalisation rate.
Stage 3 -> apply the capitalisation rate to the super profits to derive the total value of the goodwill.

When the super profits are capitalised, the calculated amount is then known as the 'capital' value of the goodwill. This final amount is determined by dividing the amount of super profits (eg.$2,000) by the capitalisation rate (eg.10%).

Therefore:

\[
$2,000/10\% = $20,000 \text{ (capitalised value of goodwill).}
\]
The valuation method then requires the establishment of a capitalisation rate to represent risk. Broad guidelines for the establishment of risk have been proposed and one such guideline by Schilt is listed below.

Table 2: Risk Premiums

<table>
<thead>
<tr>
<th>CATEGORY</th>
<th>DESCRIPTIONS</th>
<th>RISK PREMIUM</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Established businesses with a strong Trade position, well financed, depth in Management, stable past earnings with a highly predictable future.</td>
<td>6-10%</td>
</tr>
<tr>
<td>2</td>
<td>Established businesses in a more Competitive industry with good finance, Have depth in management, have stable past earnings with a predictable future.</td>
<td>11-15%</td>
</tr>
<tr>
<td>3</td>
<td>Business in a highly competitive industry that require little capital to enter, no Management depth, element of risk is High, although past record may be good</td>
<td>16-20%</td>
</tr>
<tr>
<td>4</td>
<td>Small businesses that depend upon the special skills of 1 or 2 people. Larger established businesses that are highly cyclical in nature. In both cases, future earnings may be expected to deviate widely from projections</td>
<td>21-24%</td>
</tr>
<tr>
<td>5</td>
<td>Small “one man” businesses of a personal services nature, where the transferability of the income stream is in question</td>
<td>25%+</td>
</tr>
</tbody>
</table>

(Source: Schilt, 1982)

As this table indicates there are five categories of different risk premiums which must be added to the prevailing risk-free interest rate to derive a risk adjusted capitalisation rate and as such differs from a market derived capitalisation rate.

It is argued that within the analytical framework provided in this paper the most logical valuation method for determining the value of intangible asset is capitalisation of super profits. If this is the case, established fast food restaurants could possibly be expected to fall within Categories 1&2, especially franchised operations which have well developed consumer image that accompanies proven products and services.
8. The Tangible Component

The tangible component of fast food restaurants is relatively simple concept in comparison to the intangible component counterpart. The Concise Oxford Dictionary (1982, p.1082) defines tangible as “perceptible by touch; definite, clearly intelligible, not elusive or visionary”. Therefore, in reference to fast food restaurants this component consists of land and building within which facilities for seating, food preparation, serving, will be provided as well as ancillary office space and toilets. Equipment will vary according to the style of the operation. The design of buildings and the nature of the facilities in general will be specifically designed for the purpose of the efficient production of a fast food service, although it must conform to physical and infrastructure constraints. In addition, the appearance of the restaurant will often be tailored to major brand identification in the case of franchised outlets.

As a result, the tangible component of fast food outlets is highly specialised and therefore prone to functional and economic obsolescence. It follows that the ‘bricks and mortar’ value of a fast food outlet is a comparatively high risk value component in terms of real estate investment. Costs involved in customising a restaurant to suit a particular style or franchise theme are rarely recouped if the property is resold for alternative fast food restaurant purposes. On this basis it is argued that the attraction of a fast food investment is based on its ability to generate a return as a business (as opposed to real estate value).

Real estate then is usually the major part of the tangible component and consists of such factors as location, access and visibility; neighbourhood and surroundings; size of improvements and land; and the quality, utility, functional layout and design of the improvements.

8.1 Valuation Methodology of the Tangible Component

There are three approaches, which might be used to value the real estate component of a fast food restaurant. The Cost approach, the Market approach and the Income approach. The cost approach requires the estimation of reproduction cost less depreciation resulting from physical, functional and economic obsolescence. To this estimate is added land value. This approach yields the less reliable estimate of market value. Fast food restaurants are income producing purchased with the intent of deriving future benefits in terms of a cash flow. Initial purchase cost often bears no direct relevance to the current investment value.

Not surprisingly then, the income approach is generally preferred as it reflects the rationale of purchasers. The market approach to estimating market value, i.e. deducing value based on the sale prices of comparable fast food outlets would be acceptable if adequate and accurate sales data was available. Unfortunately this is rarely the case. It is to be borne in mind that there are three types of value when analysing real estate value (Hartman, R, 1996) namely:-

Existing Use Value - the value of the existing ‘user’ is willing to pay for the asset needed for business.
Market value - the value of the facility if assumed vacant. The most probable price that will be obtained on the open market, assuming a willing vendor and purchaser who are prudent and well informed etc.
Leased Value - the value of the income stream produced from an existing lease.

The valuation of equipment and other tangible components is usually on a ‘cost less depreciation’ basis in cases of going concern value or salvage or scrap value in ‘forced’ sale situations.
9. Total Asset Value

Total asset value combines both tangible and intangible assets (i.e. land, building equipment goodwill etc.) and considers the combined contribution of these assets towards the production of revenues and expenses, and therefore a net operating income. This value is also labeled going concern value.

Going concern value has been defined as the value of a proven property operation. It includes the incremental value associated with the business concern, which is distinct from the value of the real estate only. Going-concern value includes an intangible enhancement of the value of an operating business enterprise which is produced by the assemblage of the land, building, labor, equipment, and marketing operation. This process creates an economically viable business that is expected to continue. Going-concern value refers to the total value of a property, including both real property and intangible personal property attributed to business value.” (Ibid)

9.1 Total Asset (Going Concern) Valuation Methodology

Although ‘industry’ or rule of thumb methods of valuation can be used for some business valuation, going concern value of fast food restaurants should logically be based on potential net operating income generated by the tangible and intangible components of the business enterprise. An allocation of value to these components i.e. land, building, equipment, and goodwill is not necessary except for accounting and finance purposes. It is therefore logical that valuation methods involving the capitalisation of net operating income and the discounting of cash flows to a present value are utilised.

This method is represented by Figure 3 below where -
Going Concern Value = Present Value (PV) of Sustainable Net Operating Income (NOI).

Figure 3

| Land & Building | Net operating income | Present Value of sustainable income | Going Concern Value |

Such going concern value methodology will be attributable to both independent operations and corporate chains which franchise their restaurants or control them in-house with appointed managers and dedicated property divisions. The difference being the nature of intangible assets will be of a different nature as illustrated in Figure 4 below.

Figure 4

<table>
<thead>
<tr>
<th>Independent Operation</th>
<th>Corporate \ Franchised</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land &amp; Building</td>
<td>Land &amp; Building</td>
</tr>
<tr>
<td>Equipment</td>
<td>Equipment</td>
</tr>
<tr>
<td>Business Goodwill</td>
<td>Business Goodwill</td>
</tr>
<tr>
<td></td>
<td>Value of Franchise</td>
</tr>
</tbody>
</table>
The conclusion to Figures 3 and 4 is that the value of a franchise to the franchisee is the difference between the present value of the expected differences in future earnings that would flow from a franchised operation and the earnings that would flow from a comparable independent (non-franchised) operation. Conversely, the value of a franchise to the franchisor is the present value of the future income stream expected by the franchisor over the remaining period of the franchise agreement.

10. Valuation Methodology in Practice

The nature of valuation of fast food restaurants in practice is expected to differ according to the nature of ownership structure with respect to the assets of the business. For example, is the business independently operated, corporate owned and run, or corporate owned and franchised? Valuation methodology in practice, however, will not necessarily be different. Although all the interviews intended to supplement this research have not been completed at this stage, the results of interviews carried out so far are outlined below.

The Valuation of Independently Owned Business

10.1.1 The Value of the Intangible Component

Specialist business valuers have been interviewed with respect to the valuation of intangible assets for small independent businesses such as fast food restaurants. From these interviews it was determined that the 'capitalisation of super profits' (or a related process termed 'capitalisation of future maintainable profits') is the most utilised method of valuation. However, other methods such as industry standards or rule of thumb methods and discounted cash flow were used as check methods.

10.1.2 The ‘Going Concern’ or Total Asset Value

Industry standards/rule of thumb methods are sometimes adopted to determine the value of business goodwill and then added to the market value of the tangible assets used in the business. However, this is only prevalent in industries where the purchase of the tangible assets employed in the business is optional and in many instances not sold with the business eg. taxis, milk runs, etc. (Gil Wright & Associates)

With respect to fast food restaurants this paper argues that location and design of the physical assets and the significance of equipment in producing a net operating income, make any method other than an income approach to the valuation of such an asset questionable. It is often stated that the majority of finance institutions who are lenders to business almost without exception require ‘rule of thumb’ methods to be proven by methods such as the Capitalisation of Net Operating Income.

In some cases net operating income is dissected in terms of that slice which is generated by the real estate component and the residual cash flow generated by equipment and the intangible component of business goodwill. Each slice is then capitalised at the appropriate risk rate. This method takes into account the fact that different risk rates can be apportioned to investment as real estate and the other tangible and intangible components of a fast food restaurant.
10.1.3 The Value of the Real Estate Component

The Income Approach to value will probably be the most utilised method of valuation. This method calculates the economic rents of restaurants by negotiating a percentage rent on the total revenue. By estimating the total revenue of a restaurant and applying the appropriate percentage rent, the appraiser can project an economic rent, which can be capitalised to reflect current real estate value.

10.2 The Valuation of Corporate Owned Fast Food Restaurants

The nature of this type of fast food restaurant can be seen as different from the ‘Independently’ owned business for the following reasons.

The nature of its business goodwill is usually more complex and larger.

In theory franchises provide an ‘added value’ element to business goodwill. This ‘added value’ will come from a well-developed consumer image and proven product and service quality. As such it is to be assumed this will create a higher net operating income and increased going concern value which is in a sense special value to the corporate entity so as to recognise the value of trade name, intellectual property, etc.

Many corporate chains such as Kentucky Fried Chicken (KFC), etc. will provide franchise agreements which are not assignable on the open market as a “secondary sale” but have to be offered back to the franchisor on termination of the franchise agreement. As such the value of the franchise as an intangible component will be restricted to its value to the franchisor and franchisee rather than any third party as a purchaser. This changes the nature of the valuation but not necessarily the methodology.

11. Conclusion

There is nothing new about the valuation of business operations such as fast food outlets using the methodology outlined in this paper. The capitalisation of net operating income from such operations is an established and traditional valuation method.

However, the increasing complexity of the tangible and intangible components of fast food operations (and hospitality property in general) has received little attention in the valuation literature. This may be because in the past the two components have been considered to fall in a grey area between different professional disciplines ie. The Property Valuer (with respect to tangible assets) and the Accountant (with respect to the intangible components).

This paper argues that a broad conceptual framework such as outlined in this paper is required to fully understand the valuation of this type of property and hence improve the efficiency of the outcome of the valuation process. Such a framework needs to incorporate broad value determinants which influence the tangible and intangible components and in turn contribute to the make up of the cash flow from fast food operations valued as going concerns. If the valuer does not have a full understanding of the process that creates the cash flow then his/her judgement on what is an appropriate cash flow for such operations and the risk attached to them must be questioned in terms of accuracy and reliability.
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