NO. CV 04 0527376S	:	SUPERIOR COURT
AVON REALTY, LLC	:	JUDICIAL DISTRICT OF
v.	:	NEW BRITAIN
TOWN OF AVON	:	MARCH 24, 2006

MEMORANDUM OF DECISION

This is a real estate tax appeal by the plaintiff, Avon Realty, LLC, owner of a 120-bed skilled nursing facility known as the Avon Convalescent Home (hereinafter referred to as the nursing home or subject property) for the revaluation year of October 1, 2003 and the subsequent tax year of October 1, 2004. The nursing home is located at 652 West Avon Road in the town of Avon (town) and covers 7.96 acres of land.

The town's assessor determined the fair market value of the subject property to be $5,025,300 as of October 1, 2003. The plaintiff's appraiser, Courtney B. Lees (Lees) calculated the fair market value of the subject property, as of October 30, 2003, to be $3,600,000. The town's appraiser, William E. Kane, Jr. (Kane), calculated the fair market value of the subject property, as of October 1, 2003, to be $4,600,000.[1] Both appraisers

[1] Kane made corrections to his appraisal report, Defendant's Exhibit A, on the record while testifying at trial. See Transcript of September 15, 2005 (hereinafter 9/15/05 Tr.), pp. 95-96. The court notes that Kane first testified that the revised final value of the real estate was $4,650,000. See 9/15/05 Tr., p. 7.

valued the subject property, for assessment purposes, as a going concern because it is difficult to separate the value of the business of the subject property and the real estate portion that supports it. The appraisers then subtracted furniture, fixtures and equipment (FF & E) and intangibles to arrive at what they considered to be the real estate portion of the subject's value.

"The value of a going concern refers to the total value of the property, including both the real property and the intangible personal property attributed to business enterprise value." The Appraisal of Real Estate (12th Ed. 2001) p. 27.

Kane defines going concern value, as provided under the Uniform Standards of Professional Appraisal Practice (USPAP) (2002 Ed.), as follows:

> "(1) The market value of all the tangible and intangible assets of an establishment and operating business with an indefinite life, as if sold in aggregate; also called 'value of the going concern.'
>
> "(2) Tangible and intangible elements of value in a business enterprise resulting from factors such as having a trained workforce, an operational plant, and the necessary licenses, systems, and procedures in place.
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> "(3) The value of an operating business enterprise. Goodwill may be separately measured but is an integral component of going-concern value."

(Defendant's Exhibit A, p. 5.)

Lees defines going concern value similarly in that it is "composed of, but not limited to, the physical real estate, management and employees, intangibles such as a Certificate of Need [(CON)] and licenses, developed procedures, methods and systems;

marketing, advertising, and promotion already implemented; start-up expenses and established financial relationships; sources of supplies already established and inventories. A purchaser of an operating nursing home facility is buying an enterprise that includes the real estate, furniture, fixtures and equipment, and other tangible and intangible items." (Plaintiff's Exhibit 1, p. 50.)

The appraisers' going concern value methodology was influenced by the condition of the nursing home industry as of October 1, 2003. For example, Kane reported that "[a]s the nursing home industry entered the year 2003, changes in nursing home operation appeared unavoidable. Although the elderly population was larger than ever and growing, healthy nursing home profits were less than ensured. In fact, nursing home populations were actually declining as nursing home costs rise, public benefit dollars are constrained and alternative care options grow." (Defendant's Exhibit A, p. 13.) Lees reported that the basis of value of a nursing home is "in large part, the control of rates by the state of Connecticut. The . . . Department of Social Services, Office of C.O.N. and Rate Setting sets the per diem rate for long-term facilities for Medicaid patients." (Plaintiff's Exhibit 1, p. 32.)

Kane further reported that "[t]he State of Connecticut and Federal Government control the nursing home market in large part through limitations on both new construction and Medicare/Medicaid rate[2] restrictions and reimbursements. The State is currently attempting to reduce its expenditures in this area through a moratorium on new construction as well as through adjustments to the methodology used to calculate Medicaid reimbursement rates to existing facilities. The Federal Government has imposed the PPS [Prospective Payment System][3] on the Medicare revenues. Nursing homes must attract private-pay patients at higher rates than paid through Medicare/Medicaid to remain profitable." (Defendant's Exhibit A, p. 14.)

Lees also had an interesting insight into the nursing home industry, finding that "[t]he increasing complexity of the nursing home industry is resulting in a decline in the number of owner-operators having only one or two facilities. The industry has become more medically intensive and is subject to continual regulatory changes. Recent purchasers include mid-size Connecticut companies with holdings typically ranging

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"Medicaid Title XIX . . . is funded 50% by the federal government and 50% by the state government. The State of Connecticut administers the medical assistance program, to provide the poor with adequate health-care coverage." (Plaintiff's Exhibit 1, p. 32.)

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The Prospective Payment System (PPS) was "adopted as part of the Balanced Budget Act of August 1997, affecting Medicare recipients. The law included a number of mandates to curb federal health care spending. The PPS is designed to pay for services prospectively (up front) instead of retrospectively. Previously, providers were reimbursed on the basis of costs. According to the federal government, the old cost-based structure was inefficient, expensive, paid for a lot of unneeded services and encouraged overspending. The intent of the plan is to offer nursing homes an incentive to reduce costs and thus, reduce Medicare payments." (Defendant's Exhibit A, p. 13.)

between 5 and 25 facilities; and large, regional operators seeking to expand their holdings in the Northeast. In some cases, national companies have become sellers. Management of only a few Connecticut properties within a large portfolio became cumbersome during the recent regulatory changes and cost-cutting measures imposed on the Medicaid and Medicare reimbursement systems. A third category of purchasers is represented by hospitals or owners of congregate-care facilities seeking skilled beds to expand and enhance their services." (Plaintiff's Exhibit 1, p. 31.)

The subject nursing home was originally constructed in 1965 with 60 beds. In 1976, two wings were added which expanded the nursing home to 120 beds. As of the revaluation date, there were four private rooms, fifty semi-private rooms, five rooms containing three beds and one day room.

The nursing home has several functional deficiencies. For instance, because the main dining area is located in a partially above grade basement (basement), patients must access an elevator to and from their scheduled meals and activities. In addition, visitors are received in a small reception area and corridors are slightly narrow. Kane observed that the vinyl tile flooring in the living areas, common corridors, lounges and recreation rooms detracts from the patients' experiencing a "homelike environment." (Defendant's Exhibit A, p. 26.) Most patient rooms share a bathroom as well. Lastly, while the original wings of the nursing home were finished with a full wet sprinkler system, the 1976 additions were not. However, legislation in 2003 mandated that all nursing homes be fully sprinklered by July 2005. See Defendant's Exhibit A, p. 25.

Subsequent to the date of valuation, renovations were commenced in the amount of $1,000,000. These renovations were to address some of the subject's functional deficiencies. For example, the three-bed rooms would be converted into semi-private rooms. A basement area, formerly used as a children's day care center, would be converted into a physical therapy room. However, for purposes of this appeal, neither appraiser considered the effect of the renovations on the subject's valuation as the renovations would be completed after the revaluation date of October 1, 2003.

In Kane's opinion, the subject nursing home is well-maintained and considered a "good quality nursing home by current market standards." (Defendant's Exhibit A, p. 27.) As of the date of revaluation, the nursing home had a patient occupancy rate of 98.6% and was occupied by 38 private pay patients[4], 10 Medicare patients and 72 Medicaid patients.

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Lees testified that she considered the private pay census for the subject nursing home to be high with a 32% private pay payer mix. See Transcript of July 27, 2005 (hereinafter 7/27/05 Tr.), p. 76. She reported that this was "significantly above the State average of 15.8%." (Plaintiff's Exhibit 1, p. 38.) Lees attributed this higher private pay percentage to the subject nursing home having somewhat lower rates than other area facilities, a good reputation and a good geographic location. See 7/27/05 Tr., p. 77. Lees agreed that "the amount of business value within the overall going-concern value is related importantly to the private pay census." (7/27/05 Tr., p. 118.) She testified that this is so "because it's certainly extremely evident in a facility like the subject where you have a very dated piece of real estate and you have a high private pay census that they are doing something to attract those of us that have place our loved ones in a nursing [home.]" Id.

See Defendant's Exhibit A, pp. 60-62; 7/27/05 Tr., p. 149.

It is notable that "[c]urrently, there is a State freeze on Medicaid increases. The rates are frozen at 2002 levels. . . . [A]ny anticipated increase will be capped at 2% for the foreseeable future due to cost cutting measures being implemented at the State level across the board." (Plaintiff's Exhibit 1, p. 34.)

Both appraisers recognized that there is a limited market for nursing homes as a going business. In Kane's opinion, an investor specializing in health care would be the most likely purchaser of the subject nursing home. In Lees' opinion, "the most likely purchaser of the subject property could be a national or regional operator seeking to increase its network of nursing homes within the state, a mid-size local or regional operator, or a local hospital wishing to expand its patient base into the sub acute or long term care areas." (Plaintiff's Exhibit 1, p. 31.) Kane detailed how General Statutes § 19a-638 requires every prospective transferee of all, or part, of its ownership or control of a health care facility, to first request permission from the Department of Health Care Access (HCA). HCA reviews the proposed transfer and scrutinizes the financial responsibility and business interest of the transferee and the facility's ability to provide needed services. See Defendant's Exhibit A, p. 30.

Because the state of Connecticut must first approve the buyer of a nursing home, free marketability is virtually non-existent and determining the fair market value is difficult. Lees considered the sales comparison approach and the income approach to value but clearly favored the income approach. See Plaintiff's Exhibit 1, p. 65; 7/27/05 Tr., p. 46. Kane, on the other hand, considered the cost approach, the sales comparison approach and the income approach to value.

In his analysis of value under the cost approach, Kane recognized that "this value indication has not been adjusted for external obsolescence, which clearly has an adverse impact on value. . . . [and it] does not reflect any business or entrepreneurial value, nor does it include any personal property." (Defendant's Exhibit A, p. 41.) Under the cost approach, it is necessary to determine the value of the land as a component part of the valuation process. In Lees' opinion, the highest and best use of the subject property, as vacant, would be an "alternate use current with zoning" since licenses and CON are required for the construction of a nursing home. (7/27/05 Tr., pp. 23-24.) Lees stated that "[t]he income-generating capability of a property such as a nursing home is a primary consideration for investors. It is important to note that the real estate, if not sold with the current CON licensing systems in place[,] would have minimal value. In most cases it would have an alternative highest and best use resulting in shell value." (Plaintiff's Exhibit 1, p. 31.)

As part of his analysis under the sales comparison approach, Kane considered sales located in the following Connecticut towns: Fairfield, Ridgefield and Southington.

Kane determined that the revised going concern value of the subject property, under the sales comparison approach, as of October 1, 2003, was $6,000,000.[5] Kane testified that he considered the business component of his valuation to be 10% with the remaining 90%, or $5,400,000, allocated to the real estate portion of his valuation. See 9/15/05 Tr., pp. 59-60 and 64; see also Defendant's Exhibit A, p. 55. After deducting value contributions for FF & E at $300,000 and mandatory capital repairs budget at $250,000[6], Kane calculated $4,850,000 as the net real estate value of the subject under the sales comparison approach. See 9/15/05 Tr., pp. 64-65.

Under the income approach, Kane determined that the revised going concern value, as of October 1, 2003, was the rounded amount of $5,426,000. See 9/15/05 Tr., p. 93. To reach this result, Kane divided net operating income (NOI) in the amount of $738,000 by a tax-loaded capitalization rate of 13.6%. Kane testified that his revised value of the real estate component, under the income approach, was the rounded amount of $4,350,000. See 9/15/05 Tr., pp. 94-95.

Kane testified that he arrived at $4,600,000 as the final value of the real estate by giving equal weight to the sales comparison and income approaches. See 9/15/05 Tr., pp.

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As noted in footnote one, Kane made corrections to his appraisal report, Defendant's Exhibit A, on the record while testifying at trial. See 9/15/05 Tr., pp. 8 and 64.

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Kane testified that the mandatory capital repairs budget was for the installation of the sprinkler system. See 9/15/05 Tr., p. 26.

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Prior to the filing of this appeal, Lees appraised the subject property's overall going concern value, as of October 30, 2003, for Webster Bank (hereinafter referred to as the bank appraisal).[7] See Plaintiff's Exhibit 1, p. 11 ("[t]he going-concern value has not been partitioned into its real estate, FF & E or business components"). For purposes of this appeal, Lees subsequently issued a "limited/restricted report" as an addenda (addenda) to the bank appraisal. See Plaintiff's Exhibit 2. In the addenda, Lees separated out the value of the subject's real estate using the sales comparison approach and the income approach.

In the bank appraisal, Lees determined that the estimated going concern valuation of all assets, as is, under the income approach, was $6,100,000 as of October 30, 2003. See Plaintiff's Exhibit 1, p. 51. Lees also determined that the going concern valuation of all assets under the income approach, upon the completion of scheduled renovations, would be $7,700,000. See Plaintiff's Exhibit 1, p. 54.

As part of her analysis under the sales comparison approach, which she qualified as being "developed primarily in a supportive capacity to the Income Capitalization Approach[,]" Lees used three sales in Connecticut. (Plaintiff's Exhibit 1, p. 65.) Lees testified that her office verified the price paid for the entire going concern of each sale,

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The plaintiff sought bank financing for $1,000,000 in renovations, as discussed above.

not just the real estate price identified in the deed. See 7/27/05 Tr., pp. 39 and 85. Sale one, located in Southington, is a 150-bed nursing home that sold on August 2, 2002 for an unadjusted sale price of $10,200,000 or $68,000 per bed. Sale two, located in Middletown, is a 150-bed nursing home that sold on March 7, 2002 for $8,800,000 or $58,667 per bed. Sale three, located in Fairfield, is a 160-bed nursing home that sold for $11,750,000 or $73,438 per bed.

In the bank appraisal, Lees calculated the subject's unit price per bed at $65,000 by giving the most weight to sales one and two. In Lees' opinion, the price per bed calculation, the "most frequently quoted unit of comparison[,] . . . ignores variations in rates for operating margins and is indifferent to the income generating potential of an investment property." (Plaintiff's Exhibit 1, p. 64.) Citing The Senior Care Acquisition Report (8th Ed. 2003), Lees further stated that the average price per bed of 2002 sales in the Northeast was $55,100.

In the addenda, Lees employed the income approach and considered the allowable fair rent that the state of Connecticut provides as part of the Medicaid reimbursement rate.[8] Lees reported that General Statutes § 17b-340 (f) (5) "sets a minimum fair rent

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Lees testified that the fair rent component is the "guaranteed return to the real estate by the state of Connecticut. . . . [It] arguably is reflective of what [the state of Connecticut] considered to be the real estate value of the facility." (7/27/05 Tr., p. 56.) On the other hand, Kane testified that he did not consider the fair rent analysis in arriving at his income approach valuation. See 7/27/05 Tr., pp. 153-54. Among other reasons, it was Kane's allowance of the 25th percentile of the statewide facilities as the fair rent cost component when calculating the Medicaid rate for a convalescent home. . . . According to the most recent rate computation report, the fair rent for the subject property is $221,691 or $5.147 per diem based on the projected occupancy of 98.3%. The subject is therefore reimbursed at a rate consistent with the 25th percentile or $5.3241 per diem." (Plaintiff's Exhibit 2, p. 5.)

As reported in the addenda, Lees arrived at NOI in the amount of $222,430 by first multiplying $5.3241 per patient, per diem, and 43,070 days (reflecting 98% occupancy of the subject), then deducting a reserve for replacement of 3%. Lees applied a capitalization rate of 7% for a final rounded real estate value of $3,200,000. See Plaintiff's Exhibit 2, p. 6; 7/27/06 Tr., p. 57. In the addenda, under the income approach, Lees valued the real estate portion of the subject, as of October 30, 2003, between $3,200,000 and $4,000,000. See Plaintiff's Exhibit 2, p. 6.

As she did in the bank appraisal, Lees also conducted an analysis under the sales comparison approach in the addenda. However, Lees now used two out of the three sales from the bank appraisal[9] and added sales in Bristol and Derby.[10] See Plaintiff's Exhibit 2,

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opinion that this concept did not "take into consideration any meeting of the minds." (7/27/05 Tr., pp. 154-55.)

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Lees testified that she did not include the Fairfield sale, Cambridge Manor, in the addenda because she believed it was "not reflective of the real estate value for the subject

p. 7. In the addenda, Lees concluded that the estimated value range of real estate under the sales comparison approach was between $3,600,000 and $3,900,000. See Plaintiff's Exhibit 2, p. 8.

In addition, under the income approach, Lees used guidelines issued by the Department of Housing and Urban Development (HUD) and arrived at a real estate NOI of $607,887 (by previously apportioning 30% of the net income to business earnings). See Plaintiff's Exhibit 2, p. 4; 7/27/05 Tr., pp. 87-88. Lees capitalized NOI at 12% plus an adjusted tax rate of 1.707% for a total of 13.707%, resulting in the rounded amount of $4,400,000. Lees thereafter deducted $400,000 for FF & E (estimated at $5,500 per bed, depreciated at 40%) for a real estate valuation of $4,000,000. See Plaintiff's Exhibit 2, p. 5.

As stated in the addenda, Lees' final estimated market value for solely the real estate of the subject property, as of October 30, 2003, was $3,600,000.[11] See Plaintiff's

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facility and [she] had better sales to utilize." (7/27/05 Tr., pp. 58-59.) In Lees' opinion, Cambridge Manor "is just a superior piece of real estate built in 1988 with 455 square feet above grade per bed and it has superior layout and design." (7/27/05 Tr., p. 59.)

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On cross-examination, Lees testified that no adjustments were made for location or acreage. See 7/27/05 Tr., p. 95. On rebuttal, Lees maintained that adjustments were not necessary because the sales "fairly reflect the real estate value component of a nursing home of this genre." (7/27/05 Tr., p. 115.)

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Lees testified that this valuation was "within the middle of the range of the income approach and is well supported by the sales comparison approach." (7/27/05 Tr., p. 61.)

Exhibit 2, p. 9.

Upon the court's review of both appraisers' analyses under the going concern approach to value, it is clear that this method is extremely subjective. The court recognizes that the process requires the valuation of a total business enterprise which includes goodwill, business management skills, reputation, a trained workforce, CON, location and FF & E. It is evident that this blends into a mixture of tangible and intangible property.

It is most notable that both appraisers arrived at a going concern value of approximately $6,000,000, albeit under different approaches. Upon review of all the evidence, the court finds that a nursing home's intangibles, not its real estate, are its major components of value. As Lees observed, the real estate is worth little without the intangibles. See Plaintiff's Exhibit 1, p. 31.

Given the importance that intangibles add to the subject's valuation, the court deems it appropriate to allocate 20% of the subject's $6,000,000 going concern value to the intangibles and the remaining 80% to the real estate. After deductions in the amount of $400,000 for FF & E, as discussed by Lees, and $250,000 for mandatory capital repairs budget, as discussed by Kane, the court finds that the fair market value of the subject real estate, as of October 1, 2003, was $4,150,000.

Accordingly, because the court finds that the fair market value of the subject real estate, as of October 1, 2003, is $4,150,000, an amount lower than the assessor's valuation of $5,025,300, judgment may enter in favor of the plaintiff, sustaining its appeal, without costs to either party.

Arnold W. Aronson
Judge Trial Referee