The Latest & Greatest on Fractional Interest Valuation

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Presentation Overview

Real Estate Assets

Fractional Interests
(Holding Company)

Asset Allocation
(Operating Company)

Estate & Gift

Litigation

Special Use

Corp Asset

Real Estate Appraisal + Business Valuation

The public needs valuations for:
• Estate & gift taxation, charitable contributions
  – Lots of FLPs have been created, lots of undivided interests
• Family/partner buyouts
  – Equitable division of family assets, partner divorces
• Litigation
  – Matrimonial, partner disputes, fraud & malpractice
Presentation Overview

1. Overall context: The real estate ownership landscape
2. Professional context: The practitioner landscape
3. Keys to the valuation process
4. Your Master Key!
5. Connecting the dots – Valuation Methods
6. The discount landscape
7. Value is a persuasive story – Case of Ludwick
8. Conclusions

How the public sees it

They want and need valuations

In all sorts of circumstances, and for all sorts of reasons

How the real estate appraiser sees it

Hypothetical Market Participant

Direct Ownership Typical Conditions

Fee ownership is the real estate appraiser’s bread and butter

Overall Context –
The Real Estate Ownership Landscape
How the fractional interest valuer must see it

Hypothetical Market Participant

Direct Ownership

Typical Conditions

Partners

Manager

Mortgage

Succession

Not hypothetical, not typical, do not transfer

All these elements are known…and are facts

The real estate does not transfer at the date of value

• Its financing is known

• Its operating arrangements – management, development and other matters are known

• Most importantly, the other partners are known

• Operating conditions, cash flows may be nonmarket

• The only hypothetical concerns the subject interest

– Professional Context –

The Practitioner Landscape

• Can the public tell who is qualified? Can we?

• What does interdisciplinary qualification look like?

• A huge professional void = an opening for...

• Bad guys and hustlers

• The IRS went berserk over valuation noncompliance
The Practitioner Landscape

<table>
<thead>
<tr>
<th>Fully Qualified</th>
<th>Sincere BV, CPA Valuers</th>
<th>Asset Appraisers</th>
<th>Carefree Valuers</th>
<th>Bad guys and hustlers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Need interdisciplinary support</td>
<td>Take advantage of market</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The Practitioner Landscape

- Discount checkbox on 706, 709
- Circular 230 penalties
- Adequate disclosure requirements
- Pension Protection Act penalties and sanctions
- Next up: Nit picking adequate disclosure

**News flash: IRS Disallows FLP discounts (Chapter 14)**

*Best news for real estate appraisers ever*

The Practitioner Landscape

- IRS went berserk because the interdisciplinary void is filled by not-so-good and casual valuers
- What passes for discount valuation?
  - “I heard IRS allows 35% discounts without question”
  - “Common tenancy discounts are 15%”
- Really?

The Practitioner Landscape

Assessing Professional Competency

- Business valuation is general and broad, covering all productive assets
- Real estate appraisal is highly specialized
- Valuation issues cross over discipline boundaries
- What does it take to achieve competency?
The Practitioner Landscape

Assessing Professional Competency

- Real estate appraisal plus a limited application of:
  - Accounting – balance sheets & operating statements
  - Financing – mortgage loans
  - Legal – operating and other agreements
  - BV process – apply market data to facts

Command of real estate facts = a huge advantage

- Holding companies – BV is limited
- Operating companies – BV is much more complex
- Small issues can be major without understanding
- Take advantage of real estate qualifications, but take BV elements seriously – know what you don’t know

Keys to the Valuation Process
**Keys to the Valuation Process**

**Key #1: Find the Facts**
- Start with the facts – underpins everything
- Vary greatly depending on property/business/industry/ownership positions
- What would the buyer of the interest want to know? Due diligence!
  - Real estate facts are significant… and sometimes hard to find
- The valuer identifies the facts that affect value, based on market evidence

**Key #2: Connect the Dots**
This is the core of the valuation
- Facts MUST be tied to market data
  - What are the elements in the fact patterns that show up in the data?
  - This is where we need help
- This is the complicated part of the process
  - But it should be simple and easy to understand
  - Vague assertions are not connections
- What does the analysis have to do with the interest being valued?
  - This is absolutely crucial but, amazingly, does not show up in reports!

**Key #3: Tell the Story**
- Value is a story, analysis is not
- How can the appraisal user know if the story is clear and direct, makes sense?
  - Read it! Does it convince you? Anyone?
- The Court and IRS are pleading!
  - Persuade me! – *Judge Halpern, U.S.T.C.*
  - You have to tell a story… what’s the persuasive story?
    *Judge Holmes, U.S.T.C.*
  - Please tell me what your analysis has to do with the facts!
    *Chuck Morris (IRS Western States Territory Manager for E&G)*
Facts – Your Master Key

Facts: Valuation Methods

Facts & circumstances directly affect:
- Cash flow forecasts
- Balance sheet value conclusions
- Minority discount (NAV method)
- Capitalization/yield rates (income methods)
- Marketability discount (various methods)

Facts: Due Diligence

Process of discovering relevant facts can be likened to the hypothetical buyer’s due diligence process:
- What needs to be understood in order to make an informed decision?
- What would affect the interest’s value with respect to alternatives?
- What variables would be included in the purchaser’s valuation modeling?

Facts: Classifications

Facts & circumstances for asset holding companies can be classified as:
- Assets – real property/balance sheet items
- Owners – those that come with the deal
- Ownership Structure – agreements, legal environment, any defacto realities
- Financial Structure – capital structure/asset financing, distributions
Facts: Real Property Assets

<table>
<thead>
<tr>
<th>Fact/Circumstance</th>
<th>Quantitative Measure</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Income-producing</td>
<td>Cap/yield rates</td>
</tr>
<tr>
<td>• Owner-user</td>
<td>Cap/yield rates, built up to include intangible returns</td>
</tr>
<tr>
<td>• Non income-producing</td>
<td>Proxy rates based on historic price movement, land/building allocation or ground lease rates</td>
</tr>
</tbody>
</table>

Facts: Real Property Assets

<table>
<thead>
<tr>
<th>Fact/Circumstance</th>
<th>Quantitative Measure</th>
</tr>
</thead>
<tbody>
<tr>
<td>• LT Cash flow growth</td>
<td>Growth forecast</td>
</tr>
<tr>
<td>• LT Value growth</td>
<td>Market trend forecast</td>
</tr>
<tr>
<td>• Lease turnover</td>
<td>Possible CF discontinuities, holding period</td>
</tr>
<tr>
<td>• H&amp;B use changes, future development</td>
<td>Adjust cash flows</td>
</tr>
<tr>
<td>• Non-market conditions</td>
<td>Adjust cash flows</td>
</tr>
</tbody>
</table>

Facts: Real Property Assets

<table>
<thead>
<tr>
<th>Fact/Circumstance</th>
<th>Quantitative Measure</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Manager competence</td>
<td>Risk/yield rate</td>
</tr>
<tr>
<td>• Age/actuarial life</td>
<td>Restriction period</td>
</tr>
<tr>
<td>• Manager changes</td>
<td>Risk/yield rate</td>
</tr>
<tr>
<td>• Internal conflicts</td>
<td>Risk/yield rate</td>
</tr>
</tbody>
</table>
## Facts: Owners

<table>
<thead>
<tr>
<th>Fact/Circumstance</th>
<th>Quantitative Measure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Partner buyout history</td>
<td>Possible buyout formula</td>
</tr>
<tr>
<td>Willingness to obstruct</td>
<td>Restriction period and/or risk</td>
</tr>
<tr>
<td>Distribute or reinvest cash flow</td>
<td>Minority cash flows</td>
</tr>
</tbody>
</table>

## Facts: Ownership Structure

<table>
<thead>
<tr>
<th>Fact/Circumstance</th>
<th>Quantitative Measure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vote to change/amend agreement</td>
<td>Restriction period, cash flow management-related risk</td>
</tr>
<tr>
<td>Ability to withdraw/put options</td>
<td>Restriction period</td>
</tr>
<tr>
<td>Right of first refusal</td>
<td>Risk (due diligence)</td>
</tr>
<tr>
<td>Transferability</td>
<td>Risk, voting-related admission as a partner</td>
</tr>
<tr>
<td>Tiered entities</td>
<td>Risk/yield rate only</td>
</tr>
<tr>
<td>Confidentiality</td>
<td>Risk (due diligence)</td>
</tr>
<tr>
<td>Swing vote</td>
<td>Restriction period, cash flow, management-related risk</td>
</tr>
</tbody>
</table>
Facts: Financial Structure

<table>
<thead>
<tr>
<th>Fact/Circumstance</th>
<th>Quantitative Measure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan term/ balloon payment</td>
<td>Restriction period</td>
</tr>
<tr>
<td>Prepayment penalty</td>
<td>Reversion/holding period</td>
</tr>
<tr>
<td>Non-market loan terms</td>
<td>Balance sheet adjustment</td>
</tr>
<tr>
<td>Personal guarantees</td>
<td>Seller-retained risk</td>
</tr>
</tbody>
</table>

Facts: Connecting Elements

Most of the facts influence one of two connecting elements found in market data

- **Risk**
  - The minority, illiquid position has increased risk
  - Compare w/public partnerships (dividend yield)
  - Direct use in income methods

- **Restriction Period**
  - Fundamental to asset company
  - Compare w/public partnerships, restricted stock
  - Direct use in income methods

Facts: Financial Structure

<table>
<thead>
<tr>
<th>Fact/Circumstance</th>
<th>Quantitative Measure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Different class partners</td>
<td>Distribution splits and/or capital obligations</td>
</tr>
<tr>
<td>Excess cash</td>
<td>Non-operating asset, or a potential asset?</td>
</tr>
</tbody>
</table>

Facts: Restriction Period

- **Premise:** *The interest holder expects to realize its pro rata share of NAV at some future time*
  - A departure from indefinite life of operating company
  - Real estate assets are naturally connected with time cycles
  - Interest is *illiquid* as sale is *blocked* but is not *marketable*
  - So... What facts would point to the exit?
Facts: Restriction Period

• Real property assets
  – Lease turnover
  – Highest & best use differences/changes
  – Possible future development
• Owners
  – Manager age/actuarial life
  – Willingness to obstruct

Facts: Restriction Period

• Public LP Secondary Market Data
  – Annual Rate of Return Study
  – Market-wide holding periods concluded
  – Apply OLDER data to most FLPs
  – Newer data understates discount
  – Regression proves relevance

Facts: Restriction Period

• Ownership structure
  – Remaining term
  – Vote to change/amend agreement
  – Ability to withdraw
• Financial structure
  – Loan term/balloon payment
  – Mortgage loan prepayment penalty

Facts: The Master Key

The real estate appraiser has a big advantage

• Most facts and risks are property-related
  – What assumptions are built into the market value appraisal?
  – How critical is management capability?
  – What circumstances make for a disadvantageous exit?
  – What are logical long-term objectives?
  – What must be changed in forecast cash flows?
  – Most clients don’t know this is a business valuation problem
Connecting the Dots — Valuation Methods

Valuation Methods

Facts & circumstances are expressed in:
- Asset values
- Cash flows
- Risk-adjusted yield rates
- Restriction period
  For quantitative analysis

Valuation Methods

What do we do with all these fact observations?
- Our task is to model process of buyer/seller
- Connect elements with market observations (direct & proxy)
- Approaches to value in the BV domain
  - Asset accumulation
  - Market (guideline co, direct sales, studies)
  - Income (enterprise or discount cap/DCF)
  - Other (option pricing, excess earnings, rules of thumb)

Valuation Methods

Selection based on organizational structure, rights
- LP, LLC and other highly restrictive structures match public limited partnerships
- Common tenancy and many general partnerships allow much greater control
- Methods are applied differently based on structure
Valuation Methods

- Entity/asset level Partnership/LLC
  - Public LP data
  - Public market for minority interests
  - Marketability Data
  - Private market for minority interests

- Entity/asset level CT/GP
  - Direct and proxy data based on risk/restriction
  - Private market for minority interests

---- Restriction applies until pro rata asset value can be realized

Valuation Methods

- Income methods
  - Partition time and cost ("cost-to-partition")
  - Constant growth/present value (QMDM)
  - Discounted future returns

  *Income methods are fundamental, as risk and holding period are basic points of comparison for nearly all applicable methods*

Valuation Methods

- Comparative company methods
  - Direct sales of fractional interests
  - Proxy data – restricted stock transactions
  - Public limited partnership transactions
  - Short-term liquidating partnership transactions

  *Public limited partnerships are the most important source of market data – data that are easily abused*
Valuation Methods

- Comparative company methods
  - Direct sales of fractional interests
  - Proxy data – restricted stock transactions
  - FMV Opinions and Pluris restricted stock databases
- Other methods
  - Option trading models

Valuation Methods

- Avoid these suicidal shortcuts
  - Minority discounts from partnership discount study averages
  - Fail to account for partnership expected remaining term
  - Apply BV marketability studies to real estate partnerships
  - Calculate discounts for fractional interest transactions
  - Use asset-level rates to discount partition costs and proceeds
  - Fail to consider the hypothetical seller

Beware of shortcuts and misapplication of methods!

- Shortcuts are very common...so are audits
- Being "conservative" by understating the discount? Keeping the LP discount < 35% to avoid audit? How is this not bias?
- An understated discount shorts the client's tax benefit
- What about intra-family asset division? Now what does "conservative" mean?

Valuation Methods

Minority discount from partnership averages

- Public limited partnership secondary market data underlies most control discount analysis
- The author provides a discussion of the data annually, showing averages for data groupings
Valuation Methods

Minority discount from partnership averages

<table>
<thead>
<tr>
<th>Category</th>
<th># of Programs</th>
<th>Average Discount</th>
<th>Average Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity - Distributing (low or no debt)</td>
<td>6</td>
<td>21%</td>
<td>7.0%</td>
</tr>
<tr>
<td>Equity - Distributing (moderate-to-high debt)</td>
<td>14</td>
<td>25%</td>
<td>6.6%</td>
</tr>
<tr>
<td>Equity - Non-Distributing</td>
<td>11</td>
<td>47%</td>
<td>0%</td>
</tr>
<tr>
<td>Triple-Net-Lease</td>
<td>15</td>
<td>12%</td>
<td>7.5%</td>
</tr>
<tr>
<td>Undeveloped Land</td>
<td>2</td>
<td>43%</td>
<td>0%</td>
</tr>
<tr>
<td>Mortgage Loans</td>
<td>3</td>
<td>35%</td>
<td>10.0%</td>
</tr>
</tbody>
</table>

Familiar? Appraisers apply such averages quite frequently, but...

According to the study’s author “Appraisers using this data when valuing a noncontrolling interest in an entity owning real estate should be careful not to use general averages from this survey which can be inappropriate.” This legend is included in every study.

Oops!

Judge Halpern (USTC) takes appraisers to task in Peracchio for their use of averages

His presentations to USTC Judges, and at the 2011 Symposium, emphasized that statistical issues were built into the evidence presented, but the appraisers lack of understanding made their evidence useless.

Which describes the data? How do you know? How can it be applied to the subject facts?
Valuation Methods

Minority discount from partnership averages

- Judge Halpern says don’t do it, Spencer Jefferies (partnership data publisher) says don’t do it
- The partnership dataset is very rich, and readily analyzed using online and offline tools

Valuation Methods

Fail to account for partnership remaining term

- Partnership Profiles Rate of Return Study shows forecast liquidation horizons for public partnerships
- Most family partnerships have long restriction periods – old data must be included with new
- Tip – problem is easily solved with multiple linear regression modeling

Valuation Methods

Apply BV marketability studies to RE LPs

- Control impairments are very different for businesses as compared with real estate holding companies
  - Business control is largely expressed in cash flows
  - Fixed assets are usually less important
  - Control discounts are fairly low
  - Restricted stock studies apply for low- or no-dividend companies

Valuation Methods

Apply BV marketability studies to RE LPs

- Real estate holding companies show very large control discounts
  - Loss of control prerogatives is expressed in the discount, not in the cash flows
  - Real estate generates yields (and growth rates) that are magnified by the control discount
  - Long restriction periods are difficult to match
  - Less of a problem for general partnerships and cotenancies
Valuation Methods

*Apply BV marketability studies to RE LPs*

- The solution
  - Restricted stock studies are OK for support – there actually *are* substantial discounts for loss of marketability – and should be discussed in the report
  - Place greater reliance on income methods which *do* accommodate higher cash flows and growth rates

*Use asset-level discount rates for partition*

- Partition analysis is required if the subject interest has that right and it’s feasible
  - Partition analysis is based on the discounted present value of costs and proceeds of property sale or division
  - A partition action is a lawsuit – with real counterparties
  - Cases almost always cite 10% as the discount rate
  - REALLY? Going into a lawsuit for a real estate return?

*Calculate discounts for fraction transactions*

- Direct sales of fractional interests can be useful IF
  - They indicate the discounts in the mind of buyer and seller
  - Fact patterns can be reasonably compared with the subject
  - Equity positions can be known
- Direct sales can easily be unreliable IF
  - The discount is calculated by someone other than a party to the transaction

*Fail to consider the hypothetical seller*

- Analysis usually concerns the hypothetical buyer (an outsider), but...
  - The hypothetical insider needs to have a compelling reason to exit at the concluded price
- If it isn’t addressed, it isn’t part of direct testimony, and the IRS can take an unopposed position...
Valuation Methods

*Fail to consider the hypothetical seller*

“We find incredible the proposition that any shareholder of Big M would be willing to sell his or her stock at such a large [70%] discount.” – Judge Laro in *Mandelbaum*

- Analysis usually concerns the hypothetical buyer (an outsider), but...
- The hypothetical insider needs to have a compelling reason to exit at the concluded price

The Discount Landscape

- Based on my own valuation models
- ...and 20-years of experience to
- Shows structural effects on discounts
- Conceptualizes impairment effects on value
- A method you can use to identify facts and connect the dots – helps you see and communicate discounts
- This is a work in progress...stay tuned!
Valuation Zones

- **Zone 1**: LLCs, LPs etc. long life
  - Little or no control, no exit
  - Shorter life, more control → Zone 2
- **Zone 2**: General partnerships, common tenancies
  - Control affects risk, ability to exit
  - Locked in, low-value, other impairments → Zone 1
- **Zone 3**: Real estate impaired by facts/circumstance

**Zone 1: Upper Limit Basics**

- Asset: Higher risk, say mobile home park
- Financial: Moderate to high, maybe refi risk
  - Revenue growth limited
  - Pro rata distributions @ 2.5% on NAV
- Owners: Management change, disputes
- Hold period 4-10+ years
- You would not be thrilled to be in this partnership

**Zone 1: Lower Limit Basics**

- Asset: Moderate risk, say apartments
- Financial: Low/no leverage
  - Revenues grow ≥ inflation
  - Pro rata distributions @ 6.5% on NAV
- Owners: Competent management, long history
- Hold period 4-10+ years
- You would like to be in this partnership

**Zone 2: Lower Limit Basics**

- Asset: Moderate risk, say apartments
- Financial: Low/no leverage
  - Revenues grow ≥ inflation
  - Pro rata distributions @ 6.5% on NAV
- Owners: Competent management, long history
- Hold period 1-6 years w/put or partition right
- Some influence over management decisions
Zone 2: Upper Limit Basics

- Asset: Higher risk, say mobile home park
- Financial: Moderate to high, maybe refi risk
  - Revenue growth limited
  - Pro rata distributions @ 2.5% on NAV
- Owners: Management change, disputes
- Hold period 1-6 years w/put or partition right
- Onerous risks, impaired exit

Zone 3: Property Impairments

- Change in highest & best use
- Changing market conditions
- No market data
- Impaired credit markets
- Permissions, external risk
- Discount a function of extra time, risk

Case of Ludwick

- Judge James S. Halpern; TC Memo 2010-104
- Couple builds $7.25 million Hawaii vacation home
- Gift 50% interests to two trusts
- Taxpayer 30% discount, IRS counters 15% then 11%
- Where are the facts? Not the important ones
- Were the dots connected? Apparently not
- Did the judge get a persuasive story? No

Value is a Persuasive Story
Case of Ludwick - Facts

- Where are the facts?
  Mostly about ownership and transfer
  The Ludwicks had just built the house
  And...?
  Say I'm the (hypothetical) buyer. What do I need to know?
    - Who is my “partner?”
    - How do they use the property?
    - Do I get an intangible return too?
    - How long will I be in the “deal?”

- “Suppose husband had sold his interest. If the buyer then told wife that he wanted to sell the property, what are the odds that she would object?” Really?
- Court accepted that opposition is possible, but concludes only a 10% chance
- The case turned on guesswork = made up facts. Why?
- The facts form the basis for all legal argument – and valuation as well.

Case of Ludwick – Connections

- Were the dots connected?
  Experts compared the subject valuation to
    - vague fractional interest transactions
    - compare to partnership transactions
    - conclusions from broker surveys – and others
  Judge Halpern:
    “We do not find the analysis of either expert convincing”
    “The surveys provide little guidance”
    “We find the tender offer analysis unhelpful”
    “We are not convinced”
Case of Ludwick – The Story

• A persuasive story?
  Apparently not. A frustrated Judge Halpern tossed all
  expert opinions and made his own analysis:
  Buyer would pay no more than cost to partition
  90% chance of exit in one year
  10% chance of exit in two years (other party
  contesting)
  Present value of costs/proceeds at 10%*
  Concluded 17% discount

Conclusions

• Professional disconnects are a huge issue – lots of
  ways to create disasters
• Now that you understand how it works, you can
  turn it around and take advantage of opportunities
• Remember the Ludwicks and tell the story; it
  didn’t work out so great for them, unfortunately
• You can now have confidence that it will work out
  for your clients

Conclusions

• Your access to critical facts is the Master Key to
  winning fractional interest valuations.
• Facts & circumstances drive the entire value
  analysis and produce holding period and risk
  measures suitable for connecting the dots.
• Model shortcuts are seriously risky, and should be
  avoided.

Thank you!

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