The Latest & Greatest on Fractional Interest Valuation

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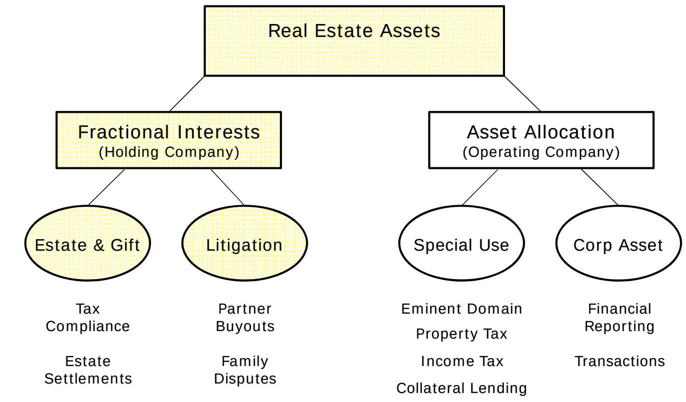
SCCAI Eastern Branch Chapter Meeting
Pasadena, CA September 16, 2015

Real Estate Appraisal
+
Business Valuation

Presentation Overview



Presentation Overview

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

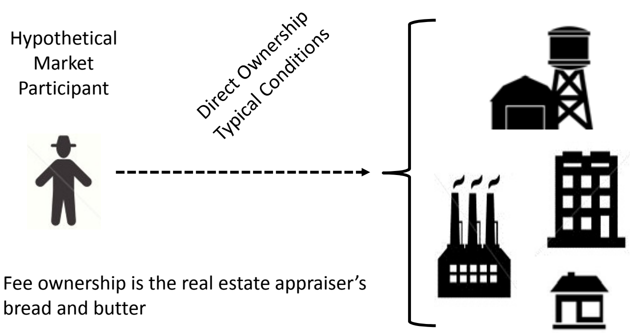
They want and need valuations

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

– Overall Context –

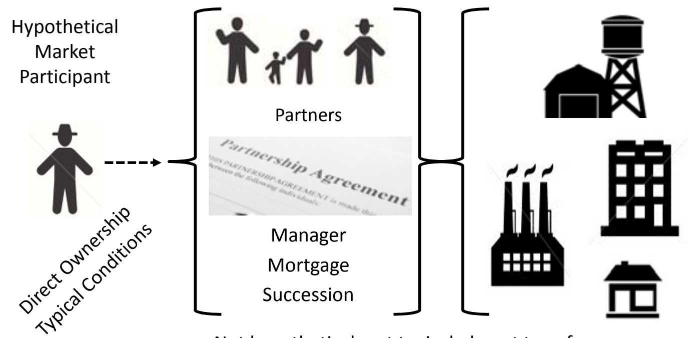
The Real Estate Ownership Landscape

How the real estate appraiser sees it



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

How the fractional interest valuer <u>must</u> see it



Not hypothetical, not typical, do not transfer
All these elements are known…and are <u>facts</u>

How the fractional interest valuer <u>must</u> see it

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

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>
<tr><td rowspan="2">Fully Qualified</td><td>Sincere BV, CPA Valuers</td><td>Asset Appraisers</td><td>Carefree Valuers</td><td>Bad guys and hustlers</td></tr>
<tr><td colspan="2">Need interdisciplinary support</td><td colspan="2">Take advantage of market</td></tr>
</table>

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

- 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)

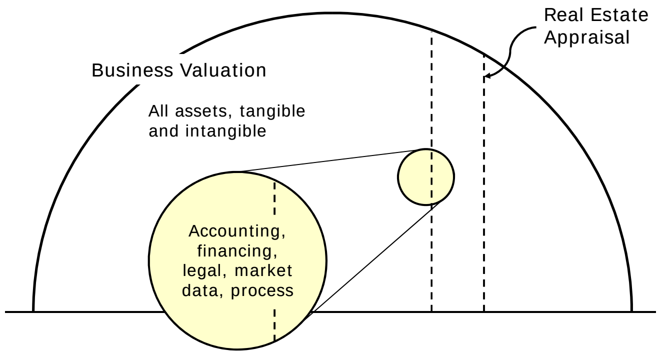
Best news for real estate appraisers ever

The Practitioner Landscape

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



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

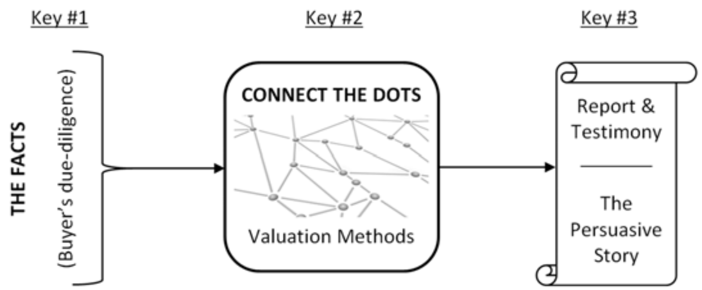
The Practitioner Landscape

Command of real estate facts = a huge advantage

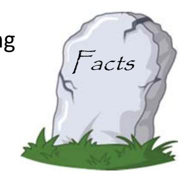
- Holding companies – BV is limited
- Operating companies – BV is much more complex
- Small issues can be major without understanding
- Take advantage of real estate qualifications, *but* take BV elements seriously – know what you don't know

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!
  - Who knows? The client/business owner? Of course.
  - 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: 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: 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: 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

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

Facts: Real Property Assets

Fact/Circumstance	Quantitative Measure
• LT Cash flow growth	Growth forecast
• LT Value growth	Market trend forecast
• Lease turnover	Possible CF discontinuities, holding period
• H&B use changes, future development	Adjust cash flows Restriction period
• Non-market conditions	Adjust cash flows

Facts: Real Property Assets

Fact/Circumstance	Quantitative Measure
• Income-producing	Cap/yield rates
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Facts: Owners

Fact/Circumstance	Quantitative Measure
• Manger competence	Risk/yield rate
• Age/actuarial life	Restriction period
• Manager changes	Risk/yield rate
• Internal conflicts	Risk/yield rate

Facts: Owners

Fact/Circumstance	Quantitative Measure
• Partner buyout history	Possible buyout formula
• Willingness to obstruct	Restriction period and/or risk
• Distribute or reinvest cash flow	Minority cash flows

Facts: Ownership Structure

Fact/Circumstance	Quantitative Measure
• Remaining term	Restriction period
• Capital call provisions	Risk, cash flows
• Distribution splits	Cash flows, risk
• Confidentiality	Risk (due diligence)
• Swing vote	Restriction period, cash flow, management-related risk

Facts: Ownership Structure

Fact/Circumstance	Quantitative Measure
• Vote to change/amend agreement	Restriction period, cash flow management-related risk
• Ability to withdraw/ buyout/put options	Restriction period
• Right of first refusal	Risk (due diligence)

Facts: Ownership Structure

Fact/Circumstance	Quantitative Measure
• Transferability	Risk, voting-related admission as a partner
• Tiered entities	Risk/yield rate only

Facts: Financial Structure

Fact/Circumstance	Quantitative Measure
• Loan term/ balloon payment	Restriction period
• Prepayment penalty	Reversion/holding period
• Non-market loan terms	Balance sheet adjustment
• Personal guarantees	Seller-retained risk

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Facts: Financial Structure

Fact/Circumstance	Quantitative Measure
• Different class partners	Distribution splits and/or capital obligations
• Excess cash	Non-operating asset, or a *potential* asset?

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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

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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?

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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

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

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: 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?

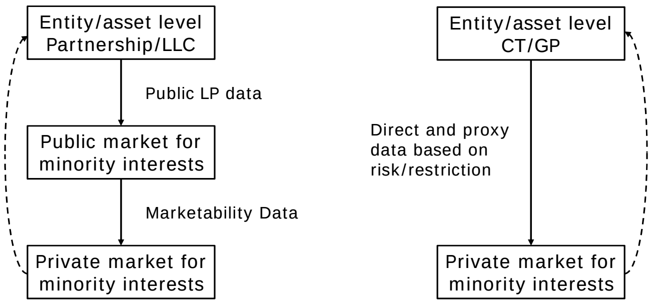
- Our task is to model process of buyer/seller
- Connect elements with market observations (direct & proxy)
- Approaches to value in the BV domain
  - Asset accumulation
  - Market (guideline co, direct sales, studies)
  - Income (enterprise or discount cap/DCF)
  - Other (option pricing, excess earnings,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

Valuation Methods

Selection based on organizational structure, rights

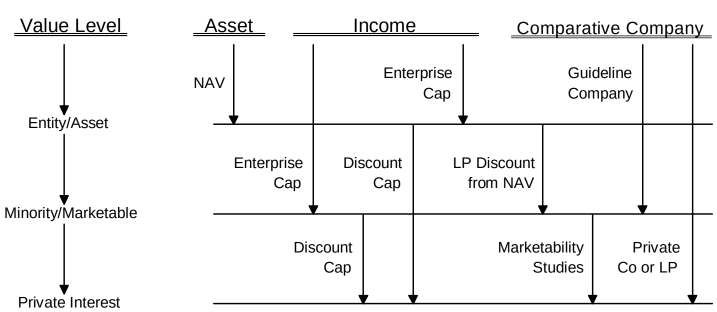
- LP, LLC and other highly restrictive structures match public limited partnerships
- Common tenancy and many general partnerships allow much greater control
- Methods are applied differently based on structure

Valuation Methods



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

Valuation Methods



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

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

- 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

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

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

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Valuation Methods

Minority discount from partnership averages

- 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!

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Valuation Methods

Minority discount from partnership averages

- 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

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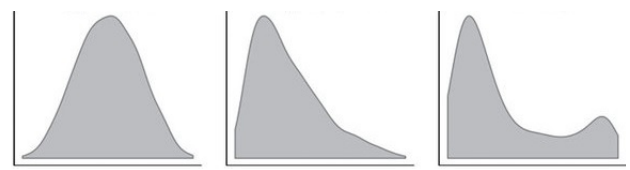
Valuation Methods

Minority discount from partnership averages



Which describes the data? How do you know?

How can it be applied to the subject facts?

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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

1994	10 years
1995	8
1996	6
1997	5
1998	5
1999	5
2000+	4

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

Valuation Methods

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

Valuation Methods

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?

Valuation Methods

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…

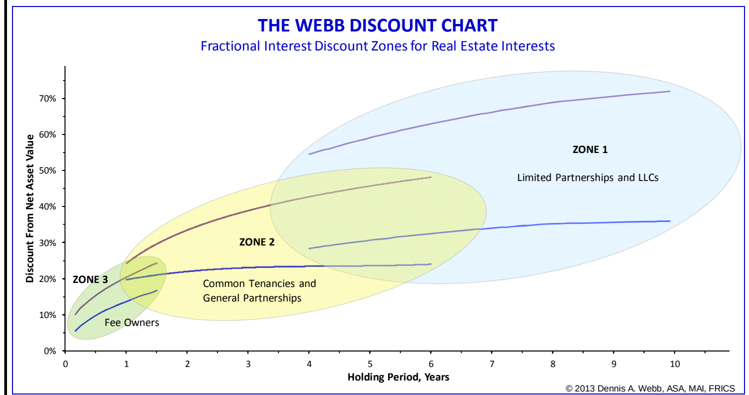
Valuation Methods

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



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

Value is a Persuasive Story

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*

Case of Ludwick - Facts

- Where are the <u>facts</u>?
  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?"

Case of Ludwick - Facts

- "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 <u>dots connected</u>?
  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

- 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.

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

Thank you!

Dennis A. Webb

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