

## Guest Article

### Why NAV May Not Be The Best Method for Valuing Multi-Tiered Entities

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Despite the recommendations of Revenue Ruling 59-60 §5(b), the net asset value (NAV) method may not be the correct approach for valuing a many-tiered asset-holding company, based on theoretical as well as practical grounds, including the “bottom-up” process of layering discounts.

Rev. Ruling 59-60 “suggests” that an appraiser place greatest weight on adjusted net asset value (NAV) when appraising closely-held investment or real estate companies. However, appraisers should avoid blind application of this method; in certain circumstances, it can violate its own premise of value as well as contradict the facts and circumstances of the case. When the subject interest holds multiple vertical entities, using the NAV method to analyze the fair market value at each ownership level may produce unreasonable (and possibly incredible) results.

Consider the example of an FLP, which holds a membership in an LLC, which holds a co-tenancy interest in real property. The appraiser’s application of sequential control/marketability discounts, from the bottom up, might result in the data shown in Figure 1.

#### What’s wrong with this picture?

Following the math on this bottom-up approach, a real property value of \$100 produces an implied 52% yield at the Subject Interest level. A 52% yield is a venture capital rate—and rarely can you justify this kind of return on real property assets, regardless of the layered structure. Real estate prices move far too slowly. Moreover, the NAV method assumes a hypothetical buyer/seller at each vertical tier, applying discounts on top of discounts; it fails to consider that the FLP is not a hypothetical seller at this point: It is a known entity that can potentially force the sale of the real property—while the subject interest cannot.

Additionally, any right to force the sale of co-owned real estate would be attributed only to a cotenant (in the above example, the LLC). Such a right would not flow through to LLC members or the subject FLP minority interest. The cotenant in this case is not hypothetical: it is known, and a cotenancy discount does not necessarily apply under FMV.

Thus, in many cases, applying the NAV approach to vertically-tiered entities can violate the fundamental premise of fair market value. The relationships of the subordinate tiers are *fixed at the date of value*—and are not hypothetical, which is postulated only for the subject interest under the fair market value standard. Risk typically does increase with each tier, but not as much as the example suggests.

So what are appraisers to do? It’s one thing to know that the IRS will reject a valuation based solely on the magnitude of applied discounts that are obviously inconsistent with the facts; what appraisers need to know is how to apply a reasonable method to arrive at FMV that is consistent with the facts and circumstances of the case.

#### A valuation in time

The net asset value method implicitly assumes that buyers of illiquid, non-controlling fractional interests will realize their respective pro rata shares of the underlying assets. The appraiser can estimate explicit time elements for a specific case, creating order out of an otherwise difficult set of facts. The process is essentially a DCF method.

Consider a subject partnership that holds an LLC interest, a general partnership interest, and a common tenancy position, as in Figure 2. The subject partnership's holding period is  $n$  years, during which it receives cash flow pass-throughs and reversions of the three interests at the end of the  $n$ th year.

The timeline depends on numerous internal and interactive facts, including the specific characteristics of the real property. The analyst must ask:

1. *What is the most likely holding period?* Influences include leases coming due, loan terms, local market expectations, ownership history, management changes, partner agreements (or disagreements), etc.
2. *Will the sub-entities terminate in the  $n$ th year*, with the subject realizing its pro rata share of the underlying real property? Or—
3. *Will the sub-entities continue?* If the property sells at a later time, the subject may only realize the FMV of the interest in the  $n$ th year, and not the liquidating cash flows.
4. *What if the subject sold the property before the  $n$ th year?* Is management required to distribute cash flows, or may it re-invest the majority of proceeds in a similar investment?
5. *What risks are associated with the sub-entities' cash flows?*

The last question is “leading,” as the income approach makes risk explicit. Risk for a holding company begins with the asset's character—which is convenient, as the analyst can readily extract the entity risk rates for both real property and minority level premia from published data (such as *Rate of Return [ROR]*, by Partnership Profiles, Inc.). The real estate appraisal typically provides investment rates, as do surveys such as Korpacz (PriceWaterhouseCoopers, [www.pwcreval.com](http://www.pwcreval.com)), RealtyRates.com, and others that break down the data into great detail.

As an example of rate buildup, consider the following *hypothetical* yields. An entity yield from a ROR study is 18.7%. After subtracting the generalized real property influence of 11.2% (derived in this case from the Korpacz Yield Indicator), the partnership risk premium is 7.5%. Add the subject real property yield of 9.1% (from the real property appraiser's rate or a market survey's rate of comparables), for a total yield at the minority level of 16.6%. This “base” yield rate applies to a non-controlling but liquid interest, and requires further adjustment for the entity's specific risks as well as lack of marketability.

It is critical to consider the facts and circumstances that affect each tier of the combined entity. Only after appraisers have a thorough understanding of the “whats”, “whys”, and “whens” of the subject interest and characteristics associated with the entities it holds, can they determine the most appropriate approach to use in valuing the tiered entity.

### **A valuation checklist**

Appraisers often skip important process steps for holding companies, ignoring fact patterns that often determine the appropriate valuation method. The valuation checklist below can help the appraiser select the applicable valuation methods, particularly when the analyst is determining the fair market value of an interest in a holding company with vertical tiers.

The list highlights the importance of clearly identifying all facts surrounding an assignment first, and properly addressing cash flow, control, and marketability issues as they apply to the subject

interest. In this regard, the checklist is not limited to multi-tiered entities but can be used to tackle all valuation assignments.

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	Discount/ Yield Rate	Yield	Implied Value at Each Tier
Subject yield	52.2%	\$11.50	
FLP discounts	32%/20%		\$22.01
LLC yield	28.4%	\$11.50	
LLC discounts	33%/23%		\$40.45
Cotenancy yield	13.9%	\$11.50	
Cotenancy discount	17%		\$83.00
Real Property Asset yield	11.5%	\$11.50	
Real Property Asset value			\$100.00

**The FLP Appraiser's Checklist**

- State the purpose and use of valuation assignment, the standard and valuation date.
- Describe the required reliability of the value conclusion.
- Describe the scope of the assignment (interactive with the remaining steps).
- Examine the facts: history, distribution of ownership, agreements, assets, operations, and forecasts.
- Who is the hypothetical buyer?
- What holding period scenarios do the facts support?
- What are the intentions of the controlling parties?

Based on *all of the above*, select the appropriate valuation approach: (1) asset accumulation, including the development of discounts; or (2) income approach, including preparing forecasts at the underlying asset level, quantifying risks, and applying risk-adjusted yield rates.

Asset Holding Timeline Example												
Buyer's purchase of at time 0				Subject Partnership holding period = n years				Expected wind-up of Subject Partnership in nth year				
0	1	2						n	n+1	n+2	n+3	
Subject Partnership—is an illiquid interest, holds multiple sub-entities												
Sub-entities, holding real property assets												
Sub-entity #1 – (a member interest in) an LLC—illiquid interest												
Sub-entity #2 – (an interest in) a General Partnership—interest has some control, limited liquidity												
Sell cotenancy or GP interest early?								FMV of cotenancy interest year n		Cotenancy's real property asset is sold year n+3		
Common Tenancy—limited control and partition right												

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