VALUING FRACTIONAL INTERESTS

IN REAL ESTATE 2.0

Protecting
the real worth of
hard-to-value assets
for the next generation

PVX™

Dennis A. Webb, ASA, MAI, FRICS

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Preface

Fractional interests are, quite simply, shared ownership of real estate. But fractional interest valuation is anything but simple. Fractions are curious things that are created by many circumstances, such as pooling development resources, wealth transfer/estate planning, and sharing usage of vacation homes, as well as combining investors in institutional partnerships. By these means, enormous numbers of fractional interests have been created, and they are not going away any time soon.

This proliferation of fractional interests is shifting the valuation practice area from taxation to long-term ownership management, mostly within families but also across the board, among the many different types of real estate-owning partnerships. It is a problem whose scale will grow with each passing generation. Unfortunately, fairly pricing interests is a major challenge. Fractional interests are known as "hard-to-value assets" for a reason.

The solution is education on multiple levels. The core fractional interest need is a widely shared understanding of valuation principles and process. Up-and-coming generations of professional valuers will need a solid background in fractional interest valuation so that they can provide real "value" for the real estate-owning public. Likewise, property owners and partners will need to educate themselves so that they can have more "ownership" of their own situations, and be able to foster harmony and understanding among their co-owners. The erstwhile concept of valuation as a tax-avoidance "game" (at least in the minds of some practitioners) needs to be replaced with solid concepts and practices that address a serious reality. Without a way to fairly price buyouts that is accepted and understood by all, for example, dissention and struggle are inevitable, and the ability to successfully operate shared real estate assets into the future will be challenged.

This has been the situation for a long time, but with no good way out. Professional practice has long relied on an assemblage of valuation data and methods that I refer to together as Fractional Interest Valuation 1.0 (see detail at the end of this Preface). This assemblage is very difficult to work with for experienced valuers, and nearly incomprehensible for everyone else. This book reviews the fundamentals that comprise 1.0, and then develops 2.0, a more straightforward, coherent and *usable* set of methodologies. It is attuned to the real estate asset and ownership circumstances in ways that make valuations understandable and germane for everyone involved. Version 2.0 is, literally, a *transformation* of valuation practice in this area.

Solutions for Readers

This text provides a foundation for concept and practical application, and is intended as both a broad reference for understanding value and as

a detailed work on how to prepare a fractional interest valuation. This book starts at the very beginning—with what fractional interests are and how they are created—and proceeds through two valuation cases in complete detail. Importantly, it brings together (1) recognition of the facts and circumstances that necessarily result in impaired control and marketability, and (2) understanding of how that affects the worth of fractional interests. The case studies are intended primarily to support professional valuers in their daily practice; however, the book also contains complete overviews of each topic area and a great deal of guidance concerning ownership operations and risk. It will, therefore, also be useful as a reference work for all those involved with owning fractional interests or advising on fractional interest matters.

Expanded Scope

The scope of this book has been expanded from its 2004 predecessor to include more basic guidance and concepts, expanded and usable explanations of levels of value, a deeper dive into systematic analysis of control impairments and the income approach, as well as essential new methods and concepts. It now includes a much more complete background on the *formation of fractional interests* in real estate, a review of the *professional landscape*, additional guidance that will enable property fractional interest owners to understand proper valuation analysis and reporting, and an emphasis on *three fundamental keys* needed both to develop and to understand multidisciplinary valuation.

This book codifies the *inside and outside* concept that is used to describe differences between the public, or outside, world of real estate and securities markets and the private, or inside, world of the subject partnership (or other ownership association). Such outside market facts and circumstances may be quite different inside the ownership structure. This distinction is critical to understanding and successfully applying market data for valuing the subject interest, and is used throughout this book to address the reality of "our" partnership.

The traditional *Levels of Value concept* is remade to incorporate both discounts and yield premia. They are in some respects two sides of the same coin, since applying a discount automatically increases yield, and increasing yield automatically generates a discount. Using discounts alone is restrictive, however, and begets a list of questions related to market value: What does the market do? Does it price shares based on returns? Does it even know about discounts? Including yields greatly expands the valuer's analytical capabilities.

We demonstrate new systematic ways of examining *management influences and the subjects influence on control risk*. Understanding impaired control is the single most important key to understanding real estate fractions. This book includes both Real Estate Limited Partnership (RELP) and Real Estate Investment Trust (REIT) examples and adds new management evaluation and subject control influence tools.

While this book's cases are still based on the usual *net asset value method*, an entirely new chapter details a parallel, powerful *income*

methodology that allows valuers to greatly expand the range of valuation circumstances they can handle. Companion, award-winning research involving REITs gives valuers directly usable control risk premiums. The income approach chapter dispenses with discounts entirely, allowing the valuer to skip any reliance on current net asset value (NAV), which makes determining value possible in those situations where current NAV is not meaningful, or even negative. Income methods are generally well-understood by both real property appraisers and business valuers, but have been sidelined because of a historic emphasis on discounts from NAV. I believe this analysis will eventually replace NAV discounting, as it is more meaningful and easier to understand.

A new overview of the practical extent of discounts is provided with the *Webb Discount Chart*, a range-of-discount picture that provides an overview of how pricing varies based on organization type and restriction period. It is useful for both fostering broad understanding and demonstrating how changed conditions affect discounts in one picture.

A new appendix on *option pricing models* provides a readily usable tool for determining the effect of very short holding periods on price, an effect which is commonly overstated by income methods.

A chapter addressing *special situations* has been added, so the reader can have a starting point for more complex situations that are not covered in the case studies. This book is not intended to be complete with respect to applicable valuation art and science, and reference is made throughout to essential business valuation and real estate appraisal works that are required reading for practitioners.

Fractional interests are like a puzzle, where many players each hold key pieces (facts, circumstances, documents, account information and valuation technology). Maintaining property ownership success into the future depends on an essential, shared understanding of those key pieces, which I hope this book will provide.

Organization

Part I, *Introduction to Fractional Ownership* (chapters 1–2), provides the reader with needed background and key concepts, both of which will be relied upon in the more technical case studies that follow.

Chapter 1, *Fractional Interests and Valuation*, begins at the beginning, with how fractional interests are created and why the processes described in this book will be needed. It considers the existing landscape of professional valuation practice and how this landscape is affected by the demands of this niche practice area. It then offers three keys for developing and understanding fractional interest valuations. These keys are essential for valuers and appraisers, but also for users of valuation reports including the legal profession and the courts, and for property owners.

Chapter 2, *Real Property Ownership Structures, Standards and Definitions*, introduces the fundamental Levels of Value concept, which follows the progressive impairment of an owner's property rights with the process of *discounting* from that owner's pro rata share of *net asset*

value or *owner's equity*. It describes various ownership structures including the essential concept of *inside* and *outside* (*ownership* and *markets*). It then provides an overview of the valuer's guiding ethical and professional standards, including the definitions of value that apply for real estate and for businesses, and then it discusses their application in various fractional interest assignments.

Part II, *Limited Partnership Interests* (chapters 3–7), is devoted to Case Study 1 (also Case 1), the family limited partnership scenario.

The case illustrations are progressive, with content for subsequent chapters dependent on information presented earlier. Although the chapters can be read independently, it is recommended that they be read in sequence, unless the reader is experienced in valuing family limited partnerships and common tenancy interests. While many of the concepts presented here may be elementary for the more advanced reader, they may not be familiar to other readers. Some issues are given fairly brief treatment, and all readers are encouraged to refer to the footnoted references for a more complete tutorial on topics with which they may be unfamiliar. The case illustrations, taken together, are meant to be the substance of an entire valuation report.

Chapter 3, *Limited Partnership Valuation*, provides the introductory basics of the valuation and the front matter of the valuation report. It examines the scope and approaches to the valuation, introduces key definitions, sets forth the facts and circumstances of the case including partnership and other agreements, and identifies potential legal concerns that may arise in valuation practice.

Chapter 4, *Real estate appraisal*, summarizes the real estate appraisal methodology used in Cases 1 and 2, guides valuers through the appraisal process and important sections of the report, and shows real property appraisers how to prepare reports that support fractional interest valuations.

Chapter 5, *Partnership Net Asset Value*, begins the valuation of the asset-holding business, examining the partnership's income statements and its balance sheets in order to reconcile assumptions made in the real estate appraisal for *outside* property markets with actual operations *inside* the partnership. It is the first step of the asset approach/net asset value method, and it also lays the groundwork for the income and other methods that are applied throughout the remaining chapters.

Chapter 6, *Lack of Control*, introduces the effect of control impairment on value. It provides a complete analysis of the discount for lack of control—the second valuation component of the asset approach. Besides the traditional discount data sources and methods, this chapter introduces new, systematic ways of examining management influences and the subject interest's influence on control risk; a REIT database; and a powerful yield rate measurement process for analyzing control risk, which will be used instead of the discount in chapter 11.

Chapter 7, *Lack of Marketability*, addresses the problem of the interest-holder's inability to exit the partnership, at least for a time. The

analysis is similar in many respects to the marketability impairment analysis that is usually applied for privately held interests in business enterprises generally. This Chapter also brings out particular characteristics of asset holding companies that are often misunderstood or ignored, but that are crucial to a persuasive valuation. It concludes the second discount, as well as a continuation of the yield rate analysis that will be used instead of the discount in chapter 11.

Part III, *Common Tenancy Interests* (chapters 8–10), addresses Case Study 2 (also Case 2), the common tenancy scenario. Many case illustrations are included throughout each chapter, with source documents and other references included in the appendices. As with Part II, the case illustrations in this section are progressive, and together represent the substance of an entire valuation report.

Chapters 8 and **9**, *Common Tenancy Valuation* and *Common Tenancy Asset-Level Value*, show important, detailed parallels between the valuation process that was followed for Case 1's family limited partnership ownership structure (chapters 3 and 5) and Case 2's common tenancy ownership structure. Concepts, definitions, approaches to value, rights attributable to the cotenants generally, outside vs. inside, financial statements and net asset value are all revisited. Much of the material is surprisingly similar to Case 1, but crucial differences are also identified, setting up the fact patterns that are so essential for a coherent discount analysis. These are the first steps of the asset approach/net asset value method of Case 2, but also lay the groundwork for the income and other methods that are applied in chapters 10 and 11.

Chapter 10, *Impaired Control and Marketability* is similar to chapters 6 and 7, but in this case provides a combined control and marketability impairment. It identifies and brings into the same valuation process the unusual character of property rights held by the cotenant. It examines many commonly held beliefs about cotenancy discount methodology, combining the overall fractional interest discount analysis for partnerships and cotenancies into a coherent whole.

Part IV, *Bringing it all Together*, expands the valuer's capabilities with powerful income methodology and a modification that allows short-term circumstances to be easily accommodated (chapters 11–12). It concludes this book with a list of special situations (chapter 13) and a brief overview of the new online fractional interest valuation tool, PrimusPVX® (chapter 14). Part IV is Fractional Interest Valuation 2.0.

Chapter 11, *The Income Approach*, expands on the income approach elements that were used in chapters 5, 6, 7, 9 and 10. The use of income methods in Cases 1 and 2 showed that yield to the interest-holder can be a more important determinant of market pricing than discount from net asset value. This chapter dispenses with discounts entirely. It also allows the valuer to skip any reliance on current NAV, which makes determining value possible in those situations where NAV is not meaningful, or even negative. Income methods are generally well-understood by both

real property appraisers and business valuers, but have been sidelined because of an historic emphasis on discounts from NAV. I believe this analysis will eventually replace NAV discounting as it is more meaningful and easier to understand.

Chapter 12 offers a useful breakthrough application of the *Black-Scholes Option Pricing Model* as a way to accommodate short-period analysis for which other methods are inadequate. This chapter describes a way to extend the operation of the income approach to bridge two distinct types of markets, short-term (option) and long-term (investment) models, cementing the income approach as a complete, across-the-board solution for fractional interest valuation.

Chapter 13 covers *Special Situations* that go beyond the scope of the two cases in this book and discusses many variations on fractional interest facts and circumstances that require special consideration by valuers. These include large percentage interests, multiple properties, non-cash flowing properties, working capital (balance sheet) issues, partner buy-outs, tiered entities, real estate market failure and underwater financing.

Chapter 14 gives the reader a brief introduction to *PrimusPVX*, the first ever (and soon-to-be-available) online fractional valuation tool. Professional valuers and appraisers will come to understand how they can use the site on its own or to support their existing models. Advisors and property owners will be able to see how they can use PVX as a learning tool—to understand how specific facts affect value, or even to conclude value for an interest in situations where a qualified appraiser is not required. PrimusPVX will do the technical work presented in this book so users can concentrate on understanding the facts and circumstances of their partnership. The site is very close to completion as of this printing, so readers who familiarize themselves now with the basics of PVX will be ready start their first project as soon as they subscribe."

Appendices A–D provide case-related documents, market data and reference materials that support the valuation process illustrated in this book. **Appendix E** presents the *Webb Discount Chart*, a range-of-discount picture that provides an overview of how pricing varies based on organization type and restriction period. The chart has proved quite useful for explaining how discounts vary reliably based on specific sets of circumstances.

A specialized **Glossary** for fractional interest valuation is needed because this is a multidisciplinary field, and each field has its own nomenclature, sometimes using different terms for similar concepts and conversely, identical terms having different meanings. The glossary is intended to be useful for specialists in different fields, as well as for property owners and advisors unfamiliar with important terms of art.

The 2.0 Technical Story for Valuers and Appraisers

The valuation professions have, until the present time, been working with Fractional Interest Valuation 1.0 when it comes to real estate holding entities and tenancy-in-common. I use the v1.0 reference because the body of knowledge was developed over many decades for operating companies, but real estate holding companies have been largely an afterthought. Until now, valuation practice, including some of my own work, has mostly consisted of adapting marketability discount and other data and thinking for use with real estate. But this has proved difficult, since the reader might need to be convinced, for example, that restricted stock has something to do with common tenancy or partnership interest discounts—not an easy feat by any means. Implementing Version 1.0 has been a real mess, as any reading of tax court cases or discussions with IRS valuers will attest. Yet even the 2004 predecessor version of this book operated for the most part in v1.0, because it was all we had.

The time has come to upgrade to Fractional Interest Valuation 2.0. Our understanding of v2.0, is founded on the fact that real estate holding companies are not operating companies. They are *real estate* entities, which means that the risk profile of the property itself must inform nearly all of the components of the valuation. But those components were developed in a securities context, as is appropriate to their business valuation origins. Even the two that are inherently real estate-related—partition and RELP trading—are still partly divorced from their real estate components. The essential characteristics of the underlying property, growth expectations, cash flow potential, risk profile, highest & best use discrepancies, etc., rarely inform either the data or analytical models that use the data.

Version 2.0 is transformative. It still builds on the many decades of the business valuation (BV) body of knowledge for marketability discounting, public partnership trading and option pricing models, but it adapts each specifically for real estate entities. Reliance is placed most heavily on income methods using RELP and REIT market returns. The result is a coherent and reasonably easy-to-explain process that supports all of the variations in circumstances that may be faced by real estate entities.

The work you are about to read is essentially an engineered approach to fractional interest valuation. Engineering methods involve combining knowledge developed by the sciences to solve specific problems. The engineer doesn't introduce anything new per se, but applies knowledge of what already exists to produce solutions in ways that might not have been thought of before. This was needed because bringing together all of these elements has proven to be a major challenge for valuers, and lacking an integrated, coherent view has been a major impediment to understanding by professional advisors and the public. This book is the end product of a long-term effort to engineer a comprehensive solution for a new generation of valuers, and for new generations of property owners as well. It is time for a change.

Background

A brief history of body-of-knowledge development will illustrate the foundations of 1.0 and much of the material from which 2.0 was developed.

Marketability discount analysis was pursued for securities of public, and later, private, operating companies between 1966 and 1969 by the U.S. Securities and Exchange Commission (SEC), along with a flurry of studies of restricted shares of public companies that continue to this day. Stout and other studies afford some ability to apply marketability data to private companies, but are limited in their ability to deal with real estate investment companies. See chapter 7.

Income methods are emphasized by Chris Mercer in his seminal *Quantifying Marketability Discounts*, published in 1997. His introduction of conventional income methods made possible a rigorous and subject-specific application directly related to market observations of restricted stock trading. It even offers limited application for real estate holding companies. While not without its share of criticism, its underlying conventional methodology has been widely adopted. See chapter 7.

Cost-to-partition analysis for common tenancy interests was advanced by the IRS, which later acknowledged that other methods had a place, too. The original, highly flawed methodology has been refined and is now recognized as a sensible income method (the Partition Time and Cost method in this book), and is routinely applied as such, even by the tax court. See chapters 8 and 10.

A method involving sales of common tenancy interests was analyzed by Harris in 1983, Humphrey in 1998, and many others since then. This method is not as developed as it might have been, since usable data are quite expensive to acquire, and valuers generally keep transactional data to themselves rather than publishing. This method contains enormous risks for the unwary; See chapter 10.

Partnership trading data have been published by Partnership Profiles since 1992, relying on an interesting and instructive database generated by partnership syndication activity, which was impacted by the huge decline in real estate prices in that decade. The data remain in active use for determining discounts for lack of control, although the supply of partnerships is waning. See chapter 6.

Partnership returns have also been published by Partnership Profiles, based on their database for 1994 to current. The annual Rate of Return Study offers synthetic returns for public limited partnerships and is highly usable, allowing valuers to readily apply income methods based on returns as an alternative to discounts developed from the same data. See chapters 6 and 11.

Option pricing models have been available for quite some time, having been invented by Fischer Black and Myron Scholes in 1973. While intended for, and extensively used in, public securities option trading, these models have been adapted for short-term analysis of executive stock options, and are now routinely used by business valuers. See chapter 7 and chapter 12.

This history is necessarily brief, and many more contributors that could have been credited for their own works here are cited elsewhere in this book. I do hope that those not appearing in this book or the above list will not be offended by the omission.

As for myself, I published income approach methodologies for applying marketability data to common tenancy interests first in 1997, and then regression methods for analyzing Partnership Profiles data in 1999. The 2004 predecessor version of this book included a lot of the current material, but it was still not fully integrated. With the current upgrade to 2.0, the complete and coherent picture is now available for new generations of valuers and property owners.

Part I

Introduction to Fractional Ownership

CHAPTER 1

Fractional Interests and Valuation

This chapter provides an overall context for understanding fractional interest valuation. It begins at the beginning, with a discussion of how the many fractional real estate ownership positions came to be, and how the conditions that make it a great idea going in inevitably change over time. It then assesses the valuation professions with respect to both internal conflicts and roadblocks to their mission to serve the public interest. It concludes with three keys to successful valuation that are a guide to (1) valuers doing this sort of work, (2) advisors who must use valuation services to accomplish tax compliance, and (3) both advisors and partners charged with determining price for partner buyouts.

In the Beginning: How Fractional Interests are Created

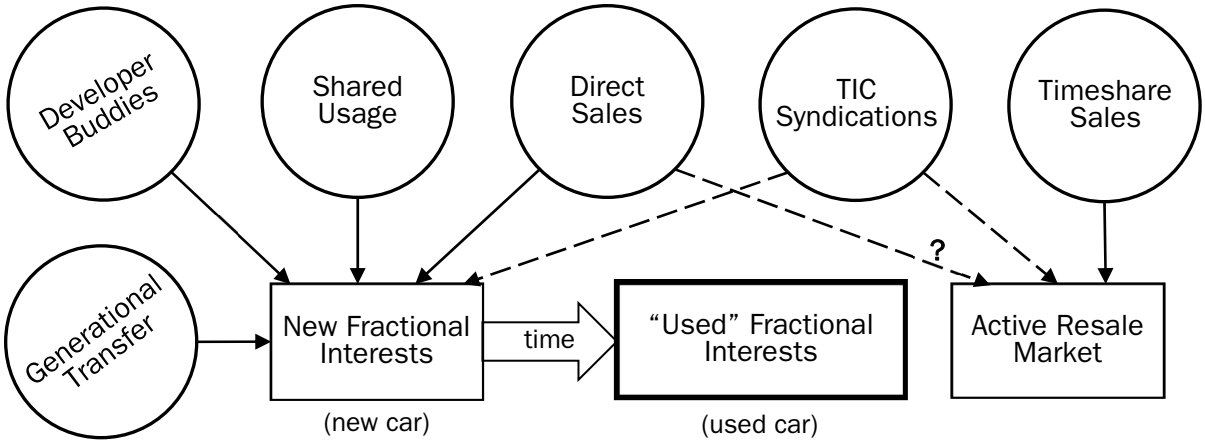
Fractional interests in real estate include all the ways that more than one party can share the same property rights among themselves. Whether deeded, as tenancy-in-common, or units or shares of legal holding entities, fractional interests all have a curious life cycle. They are mostly created at a point in time where there are substantial benefits to pooling resources for purchasing and improving property, or splitting usage of a property that would otherwise be prohibitively expensive, or buying a vacation interval—all of which are *intangible* benefits. Such interests generally are formed by investing at a premium to a specific interest's proportional (pro rata) share of a whole property. But in nearly all cases, the acquired interest is like a new car: Once you "drive it off the lot" so to speak, value declines, and often substantially. The intangible value, like the one that we associate with a brand-new car, evaporates when it is no longer brand-new. We refer to this value loss as a "discount" from the interest's share of the whole property. This discount concept is explained more fully in chapter 2.

There is obviously no discount at the time of formation, and probably for some time after that. After all, market value requires a buyer and a seller; why would a person who just got in at formation be willing to exit at a discount? If their intangible benefits remain in place, then the value to that person hasn't changed. But the value will certainly change. Conditions change over time, as do personal interests and objectives, and the interests become "used" in the sense that the perceived intangible benefits will have evaporated. Of course, if a buyer can be found years later and persuaded that the deal is as compelling as it was originally, then that buyer might indeed pay 100 cents on the dollar if he sees sufficient intangible benefit. This is *investment value* unless a market with such an objective could be found or reasonably hypothesized. While we do not find such markets for used interests, we can find many examples of investment activity concerning securities with the attributes of used interests. It is on the basis of these observations that we are able to apply discounts.

In some cases, there is an active market for the acquired share. We are not interested in these cases, since familiar valuation methods, such as the "sales comparison approach," can be used to analyze transactions and extract value indications for the subject interest. (Valuation approaches are discussed in chapter 3.) For most privately held fractional interests, there is no active market (mostly for reasons described in chapter 7). Interests having impaired or nonexistent markets are the fractional interests that are the subject of this book.

Various typical forms of fractional interest generation are shown in figure 1.1.

Figure 1.1 – Methods of Creating Fractional Interests



Development buddies pool their talents and resources to develop and hold real estate. Many enterprising owners and developers were doing this in the post-WWII period and beyond. Many of the successful developments created by these generations have ended up providing income for multiple family members that continues to this day.

Shared usage is often seen in resort communities, as parties come together in small numbers to acquire residential units that they can share, since presumably none of them will use the property year-round. For example, Summit County, Colorado once had an active market for fractional interests in ski condos, with real estate brokers listing and selling the fractions to the public. Such transactions can be done privately or brokered, involving parties not known to each other but often bound by operating agreements.

It is entirely possible that an investor in a shared usage arrangement may want to exit soon after purchase for personal or other reasons. If there is an active market, then that exit price might resemble the going-in price. If not—perhaps if a recession or other cyclical event has closed down the market—then the procedures described in this book will be needed to value the interest. (Temporary market conditions affecting whole or partial interests can be analyzed similarly, as a marketability impairment; see special situations in chapter 12.)

Generational transfers for estate planning involve family real estate assets that are gifted, passing to a younger generation at their fair market value (FMV). Since these assets often pass in fractions, the fair market value standard required by the tax code (chapter 3) means that a discount from any new holder's share of the whole (from pro rata net asset value or owner's equity; see chapter 5) will be applied. The reduced transfer value has the effect of "disappearing" the amount of the discount from taxation. (The idea of disappeared value implies that it could be recovered if ownership can be made whole again, which is often no easy task.) Of course, generational transfers are also an automatic consequence of owners passing on, and the same valuation discount applies for the new holders' shares in these situations as well.

CHAPTER 2

Ownership Structures, Standards and Definitions

Ownership Structures and Rights

Levels of Value

Inside and Outside

Professional Standards

Definitions of Value

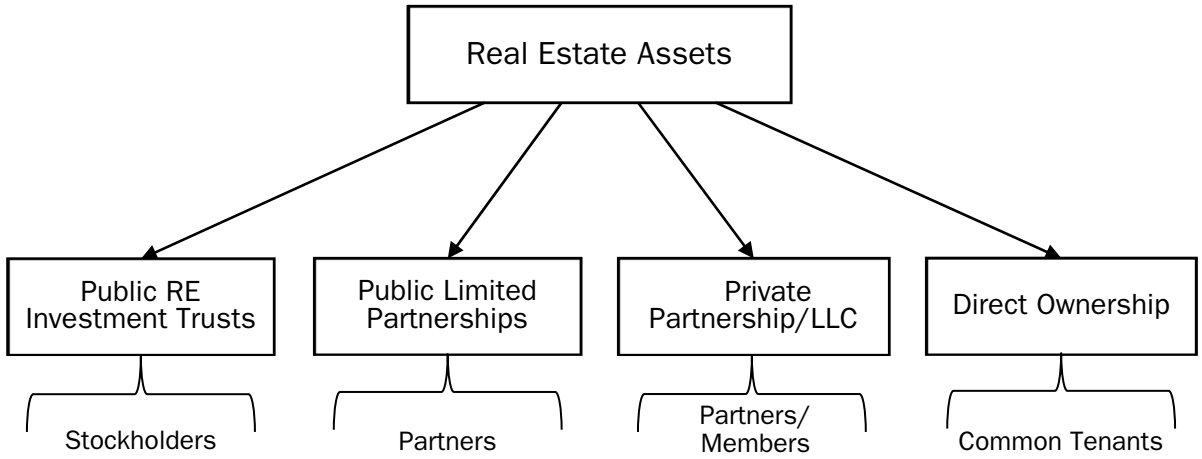
Real estate assets typically trade in active markets, and we have come to think of real estate entirely in terms of those markets. However, once an organizational wrapper is placed on real estate ownership, the property rights that are normally transacted in the market are now distributed between the fractional interest holders. This division creates a duality that demands that we recognize both the market outside and the constraints and divisions inside the partnership or other holding entity. This chapter identifies types of organization structures and the fundamental Levels of Value concept, beginning the important distinctions that will follow our analysis through the remaining chapters of this book.

Ownership Structures and Rights

Ownership of real property consists of a bundle of rights, the complete set of which is title in fee. Such ownership is a fee simple interest, subject only to governmental powers of taxation, eminent domain, police power, and escheat. The rights to real property may be divided in many ways. Real estate assets may be held in fee simple or divided into a set of property rights.[1] For example, when rights are divided between a lessor and a lessee, the lessor's right of occupancy has been assigned to the lessee, and the lessor holds a leased fee interest. This book focuses on undivided property rights, such as those held by partners and common tenants. The notion of a bundle of property rights is useful for analysis because one can think of the whole bundle (fee simple) being diminished as specific rights are transferred to others, and further diminished as they are divided among owners, among a general partner (GP) and limited partners (LPs), or among majority and minority stockholders.

When more than one owner holds interests in real estate, problems can occur. It can be useful to think about divided ownership as a form of nonphysical real estate damage, part of a spectrum of detrimental conditions.[2] Multiple ownership complicates property rights and greatly expands the appraisal process. The basic business ownership structures for real property are shown in figure 2.1.

Figure 2.1 – Ownership Structures for Holding Real Property



The ownership entities shown in the figure are legal mechanisms for apportioning rights to multiple owners, just as leases are mechanisms for apportioning rights associated with occupancy. The ownership structures

[1] For an overview of divided and undivided property rights, see *The Appraisal of Real Estate* (supra), 79, and 69–86.

[2] See case study authored by Dennis Webb, "Nonphysical Damage–Fractional Discounts," in Randall Bell, *Real Estate Damages: Applied Economics and Detrimental Conditions*, 2nd ed. (Chicago: Appraisal Institute, 2008): 266–269.

shown include partnership/limited liability companies, corporations, and common tenancies.

The case studies presented in this book are structured as a limited partnership in Part II (Case Study 1) and as direct ownership, where owners are tenants-in-common (common tenancy) in Part III (Case Study 2) Many of the same principles that apply to partnerships and common tenancies are applicable to corporate structures, but their analysis is not within the scope of this book. These basic ownership forms exhibit strong similarities but also striking differences, and these differences have created a great deal of misunderstanding and confusion.

Partnership/Limited Liability Company

A partnership is characterized by an agreement that generally specifies management responsibilities and sets forth the partners' rights, including the voting requirements for asset sales, entity termination, partner admissions, capital calls, and cash distributions.

A partnership may be either general (below) or limited. Partners in general partnerships are jointly and severally liable and typically participate in management; limited partners have limited liability, contribute capital, receive distributions, and may vote on certain issues but do not participate in day-to-day management decisions.

Members of a limited liability company avoid some of the restrictions imposed on partnerships but are not authorized to operate in all states. The LLC is similar to the limited partnership in that partnerships and LLCs both usually exist for a specified term and are pass-through entities with earnings taxed at the interest-holder level.

There are important structural differences from an analytical standpoint; for the purposes of this book only, limited partnerships and LLCs are treated in the same way. Therefore, references to the word *partnership* may be taken generally to include LLCs. This does not mean, however, that the ideas expressed here should be applied to LLCs without first consulting applicable state laws.

Corporation

A corporation is governed by a board of directors, has centralized management, and can exist in perpetuity. Stocks representing proprietary ownership may be transferred freely or may be restricted. A corporation may be taxed at the corporate and stockholder levels, or it may be a tax pass-through structure organized under subchapter S of the Internal Revenue Code (an S-corporation).

Because the focus of this book is on real property interests, references to corporations are limited to closely held asset holding companies. Corporations that hold other types of assets, or are characterized by more active operations, often have intangible assets and require valuation methods that are beyond the scope of this book. C Corporations are taxed at the corporate level, unlike S Corporations, and are also excluded because of the possibility that capital gains associated with the real estate

could be "trapped" in the corporation and would have to be accounted for in any shareholder interest valuation.

Common Tenancy

When ownership in real property is held through a holding company, the interest is held indirectly. Direct, or deeded, ownership by more than one person can take several forms: joint tenancy, tenancy by the entirety, or tenancy-in-common (common tenancy). The first two generally allow for rights of survivorship, so valuations of separate interests are not often needed. In common tenancy, the undivided interests are independent of one another and may be transferred without permission or knowledge of the other cotenant(s). It is this transferable form of tenancy that often requires valuation and is one focus of this book. Common tenancy is further characterized by the following attributes:

- typically, no agreement exists between the parties;
- voting rights are unspecified, and one owner may block nearly any decision;
- no restrictions exist on interest transfers; and
- each common tenant has the right to bring legal action to either partition the property or force its sale.

Common tenancy is still a form of association, however, and, in many important respects, may be treated as if it were an "ownership entity." This treatment is convenient for business valuation because the method of analysis used for partnerships can be applied to common tenancy, with adjustments made for the differences described above. A surprisingly broad range of valuation techniques can be applied to common tenancy, further allowing comparisons with important market data.

General Partnerships

Liability is the principal legal feature of a general partnership, but its valuation features are heavily dependent on the extent to which rights are allocated by the GP agreement. The decision-making ability for limited partners and members of LPs and LLCs is deliberately restricted so that their liability will remain limited. General partnerships don't have this constraint, and their operating agreements contain varied and sometimes surprising features.

It is useful for the valuer to consider a spectrum of control, with a basic limited partnership at one end (Case 1), and common tenancy, with no operating agreement (Case 2), at the other. (See a graphic depiction in Appendix E.) If there are enough restrictions, then partner interests in a general partnership may be sufficiently similar that they can be valued using the same process as for a limited partnership. However, if its partners have enough rights granted by the agreement, then those rights begin to resemble the rights of a common tenant, and it may be more appropriate to use the common tenancy process. Chapters 10 and 11 demonstrate ways that the value can account for the entire spectrum of

control, which is, after all, a continuous function of the subject interest's degree of control and exiting ability, regardless of how the organization structure is labeled.

Public Partnerships and REITs

Two types of publicly-registered entities, public partnerships and REITs, provide data the valuer can use to determine the price of control (discount for lack of control). They have many basic structural similarities to privately held partnerships and LLCs, but important differences as well. These similarities and differences are identified, and can be quantified for application of public trading data to private partnerships, as described in chapter 6.

Other Business Entities

Other descriptive names may be applied to agreements between property owners, such as *syndication* or *joint venture,* but these are generally considered partnerships for tax purposes.[3] Other similar business entities can pose interesting problems for valuers, since the agreement between the parties may limit control and marketability in ways that indicate that the entity should be valued as a partnership or a common tenancy. Partnership interests would be valued by the methods presented in chapters 3 through 7, Part II of this book, and common tenancy interests should be valued using the methods presented in chapters 8 through 10, Part III. Characterizing the entity is a critical step in the valuation process, and it can take some legal, as well as valuation, expertise to properly understand.

Levels of Value

The concept of *levels of value* is fundamental to organizing and understanding the valuation process. It shows the relationship between the value of a whole enterprise and the transferable ownership interests, which may be valued at less or more than the whole. For example, a business may be sold for $100 per share to a buyer who acquires all the shares, or at least enough shares to control the enterprise.

The concept of levels of value is fundamental to organizing and understanding the valuation process.

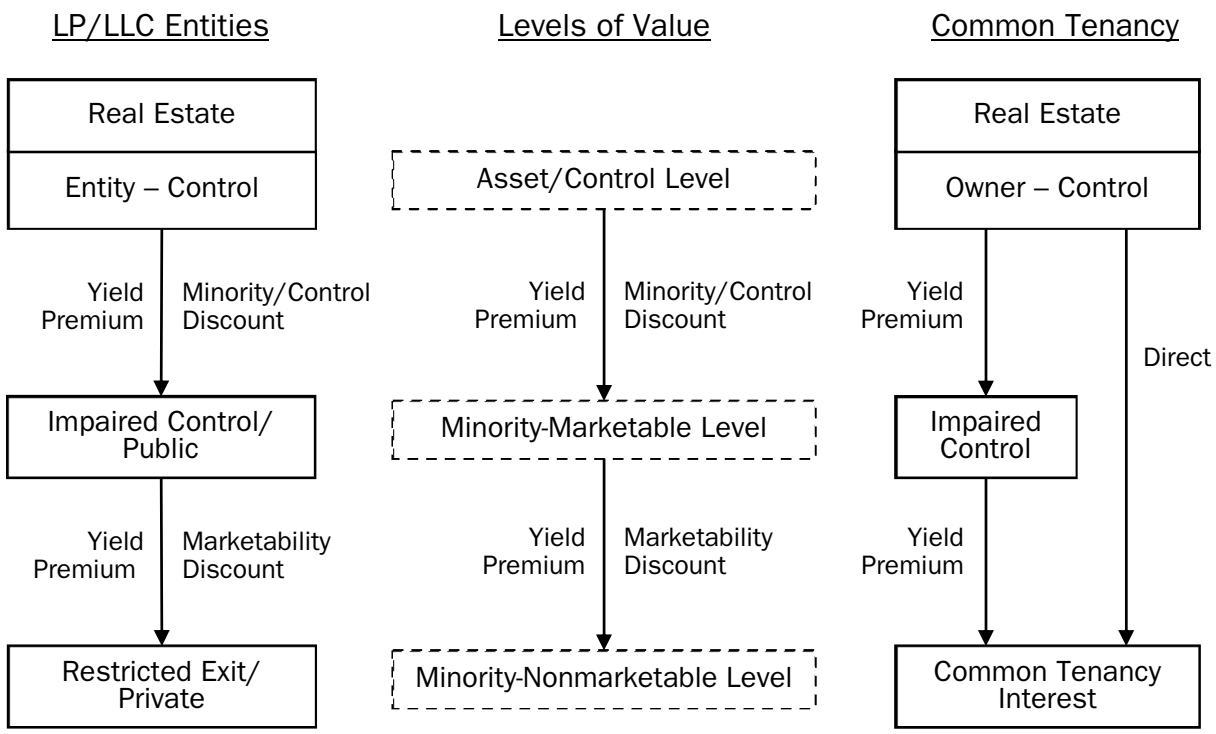
Shares that confer limited rights, such as small minority interests (typically market-traded shares of public companies), generally trade at a lower value. The Levels of Value concept has been developed by many

[3] I.R.C. § 7701(a)(2) provides (for estate and gift tax purposes) that partnership "includes a syndicate, group, pool, joint venture, or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust, estate or corporation…"

valuation experts, including Shannon Pratt[4] and Chris Mercer,[5] but most such development has concerned operating businesses, and almost no attention has been given to more than the basic discount concept for asset holding companies. This section presents the basic version with small additions, and later chapters will expand the level structure to include more useful elements that will help the valuer with different methods and specific valuation steps.

Figure 2.2, Levels of Value shows the value flow as it applies to real estate-holding entities. At the top is the asset/control level. For a limited partnership or any asset holding company, it is usually the net asset value, or equity, of the enterprise.[6] For common tenancy or any other directly-held interest, it is owners' equity. Value generally changes in two downward steps, which are related to control and exit impairments.

Figure 2.2 – Levels of Value



[4] Shannon P. Pratt et al., *Valuing a Business, The Analysis and Appraisal of Closely Held Companies*, 5th. ed. (Chicago: Irwin Professional Publishing, 2008): 384.

[5] Z. Christopher Mercer, *Quantifying Marketability Discounts* (Memphis: Peabody Publishing, 1997): 19.

[6] *Net asset value* is generally defined as the value of an enterprise's tangible assets (excluding excess assets and non-operating assets), less the value of its liabilities. We are assuming little or no identifiable intangible value, and the operation is defined as holding assets. Thus, the definition applies to the value of its assets (real property, securities, and cash) less the value of its liabilities (mortgage, security deposits, loans, etc.). NAV is usually equal to the owners' equity.

Fewer rights are associated with a minority[7] interest in an asset holding company than with direct ownership of the company's assets and liabilities. The market value of such interest is less than its simple pro rata proportion of the partnership's equity because potential buyers discount the pro rata value of the interests to reflect various factors that limit their ability to control the assets or enterprise, or to dispose of their interest, the most important of which are lack of control and lack of marketability. Accordingly, an increased yield will be required to compensate the buyer, reducing the market price for the investment and increasing the discount. (Yields and discounts are closely related, and are addressed in detail in chapter 6.)

The levels of value structure has been historically useful, in part because it provides a way for the valuer to apply various types of available market data. Minority values can be obtained from market trades of shares in public entities such as real estate limited partnerships (REITs) and real estate investment trusts (RELPs). Applying these data to the subject partnership (or LLC, or corporation) results in a hypothetical value for the interest as if it were publicly traded (i.e., with impaired control) at the minority-marketable level. The next step is to develop the discount associated with the interest's restricted exit (associated with its privately held status), at the minority-nonmarketable level. Thus, the property rights associated with the whole are reduced first for the interest's impaired control (lack of control), and then for its inability to exit for a time (lack of marketability).

For common tenancy, the asset/control level is also used as the starting point. Lack of control and lack of marketability characterize these interests, but the two-step process doesn't work in quite the same way. Figure 2.2 shows common tenancy in the right-hand column, but the minority-marketable level is not useful for most of the market data that support the discount. This is because control attributes embedded in the market data are so dissimilar that the idea of a publicly-traded entity with similar minority characteristics is too much of a conceptual stretch. It is much more analytically useful to address management risk (and subject interest influences that can mitigate that risk), and apply that analysis to determine risk-adjusted yields, as introduced in chapter 6 (and applied in chapter 10). Other valuation methods that are used for common tenancy interests all arrive at a single discount.

The common tenancy side of the figure also applies for partnerships that have a short remaining term, say fewer than four years. In that event, the partnership valuation would make use of the techniques presented in chapter 10 and especially the proxy market analysis presented in chapter 12. Case 1 presumes that the remaining term of the Partnership will exceed four years.

In sum, the Levels of Value concept is used to describe a complex multilevel process that involves taking real estate and public securities

[7] The term *minority* is usually defined as less than a 50% interest in an enterprise. This book uses an expanded notion of *minority* as meaning *noncontrolling*. *Minority* is used commonly but is a potential source of confusion.

market data and circumstances and applying them to a specific, privately held partnership or other association of property owners. The levels concept shows a vertical process that moves from the real estate asset to the restricted ownership position, identifying the losses of control and marketability that diminish the value of the privately held interest. It is quite useful for understanding this loss of rights, and the same steps will be followed through both our case studies.

Inside and Outside

The "**inside** and **outside**" concept is used to describe differences between the public, or *outside*, world of real estate and securities markets and the private, or *inside*, world of the subject partnership (or other ownership association). This is more of a horizontal concept that identifies outside market facts and circumstances that may be quite different inside the ownership structure. The distinction is critical to understanding and successfully applying market data for valuing the subject interest, and we will be making frequent reference to it in this book.

Outside market facts and circumstances may be quite different inside the ownership structure.

Organization

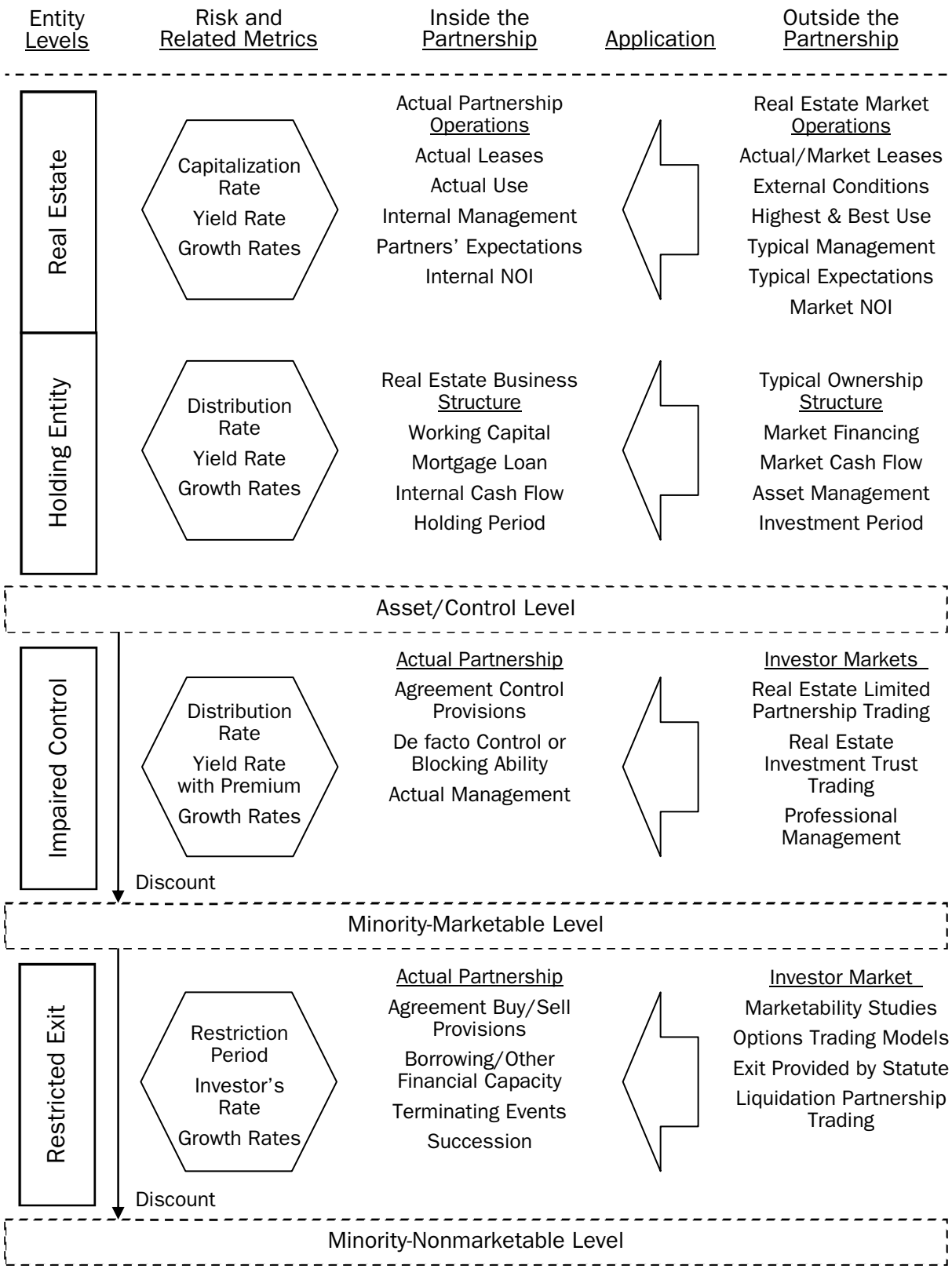
Figure 2.3 below shows the same flow as in figure 2.2, but the figure also shows how data gathered from outside the partnership—from real estate and other public markets—can be applied inside the partnership.

The left column of the Asset/Control level shows the same entity boxes from the left side of figure 2.2, Levels of Value: the real estate itself and the entity holding the real estate (in this case, the partnership). The next two boxes in the Entity Levels column match the next two steps in the levels of value: Impaired Control, at the Minority-marketable Level, and Restricted Exit, at the Minority-nonmarketable Level.

The right column shows the market data and other conditions that exist *outside* the partnership, largely in public markets that provide useful trading data. The next column, moving from right to left, represents the appraiser's *application* of those data to the subject partnership. This was referred to in chapter 1 as Key #2, Connecting the Dots. The third column describes conditions *inside* the partnership, a unique assemblage of facts, circumstances, personalities, agreements, philosophies, values and objectives that are specific to the subject partnership and its partners.

The task of the appraiser is to find relationships between the inside and outside facts and circumstances and determine how conditions observed outside apply inside—to connect the dots, so to speak. The results of the appraiser's efforts are expressed in the next column, Risk and Related Metrics. These are the analytical elements that we will apply in the valuation process to develop our value conclusion.

Figure 2.3 – Inside and Outside



Real Estate

The real estate asset is described in detail in chapter 4, Appraising the Real Estate. The real property appraiser's point of view is necessarily informed by observing the actions of buyers and sellers in the market.

The appraiser is concerned solely with how those outside market participants make decisions, based on *typical* behavior and objectives. The appraiser's analysis may or may not reflect the inside behavior and objectives of the subject partnership and its management.

Specific leases, actual use, management style and expectations may be different from what is observed in the outside marketplace. The characteristics of property ownership and management observed in the market by the real property appraiser must be interpreted and if necessary, adjusted, to match the actual operating style, philosophy and objectives of the subject partnership and its management.

The risk and related metrics column identifies capitalization, yield and growth rates that the valuer may conclude (depending on the valuation process) for the real estate as operated inside the partnership.

The valuer's concluded value is the most probable price that would be obtained were the partnership to sell its real estate asset at the date of value. However, suppose the subject partnership will not be selling the asset for some time. Then what?

Holding Entity

The partnership structure is first addressed in chapter 5, Developing the Partnership's Net Asset Value, and the common tenancy structure is discussed in chapter 8, Developing the Common Tenancy Asset-Level Value. The ownership structure will have specific legal and financial attributes that may or may not be typical. Each specific capital structure (normally based on mortgage financing) alters cash flows and risk, and imposes certain conditions on the partners (the ability to refinance, balloon payments and other significant conditions).

Other financial conditions identified on the partnership's balance sheet, along with the operating conditions identified on its income statement, lead to a concluded *net asset value* as well as specific distribution, yield and growth rates for the entity as a whole.

Such NAV is realizable by anyone who has the ability to sell the real estate. Otherwise, it is only theoretical because it is not currently accessible by the partners. They are normally constrained from selling for at least a time, making the future NAV more important than the current NAV.

Impaired Control

Impaired control is addressed for partnerships in chapter 6, Developing the Discount for Lack of Control, and for common tenancy in chapter 10, Developing the Discount for Common Tenancy Interests. Attributes of control and the lack thereof are observed in public markets, both for REITs, whose shares are traded mostly on the NYSE, and for RELPs, whose interests or units are traded in the limited partnership secondary

market. These institutional entities typically have sophisticated, professional managers, both for real estate operations and for the entity's portfolio.

The appraiser's task here is similar to the asset level, where he or she must interpret observations and various data from these markets, applying them to the specific partnership being valued. Differences usually show up in the competence and abilities of management, as well as the degree of control exercisable by the holder of the interest being valued.

The appraiser may conclude (again depending on the valuation process selected) capitalization, yield and growth rates for the real estate as operated inside the partnership, this time at the minority-marketable level. The value of the whole partnership is discounted from its above-concluded NAV, in essence discounted because of impaired control. Both of these values are still hypothetical because neither can actually be realized. They are intermediate steps on the way down to the nonmarketable level.

Restricted Exit

The assumption at the minority-marketable level is that the interest-holder has limited or no control, facing increased risk but with the option of bailing out in fairly short order. However, that is not really the case. While it is true that there may be limited control, there is always going to be some restriction in the holder's ability to exit, at least for a short time, and often for a very long time. This further limitation is addressed for partnerships in chapter 7, Developing the Discount for Lack of Marketability. The idea of restriction is also part of the common tenancy discounting process in chapter 10.

The appraiser's task is to once again observe examples of restrictions on exit found in public markets, such as in marketability studies, or in options trading models or in trades of partnership interests where a credible exit was expected at a certain future time. Exit ability can also be provided by statute (a partition right) and analyzed in the context of a court proceeding.

These outside observations are all associated with time and risk. The partnership's inside circumstances—legal (buy/sell provisions), financial (ability to actually buy out an interest), any expected terminating events (the end of the partnership's stated term), and issues around succession—all relate to the period for which the interest holder must remain in its position before it can exit with its pro rata share of the asset-level NAV. As noted above, the *exit* is the point where NAV really matters.

The restriction period, risk-compensating required return, and growth rates are the result of the valuer's analysis, and become the variables that lead to the concluded value. This last step can also be analyzed and concluded as a discount for lack of marketability. Value at the minority-nonmarketable level is no longer hypothetical. It is the concluded value of the subject interest—the price that fully considers all the limitations and risks that are imposed by the partnership structure on the interest-holder.

Professional Standards

Professional appraisal standards are essential in promoting ethical behavior and defining accepted practices and procedures for completing a valuation assignment. Standards for valuation practice include:

- *Uniform Standards of Professional Appraisal Practice* (USPAP)[8]
- *ASA Business Valuation Standards* (BVS)[9]
- Appraisal Institute *Standards of Valuation Practice* (SVP)[10]
- Appraisal Institute *Code of Professional Ethics* (CPE)[11]
- *NACVA Professional Standards* [12]
- *AICPA Code of Professional Conduct* (CPC)[13]
- IVSC *International Valuation Standards 2017* (IVS)[14]
- *RICS Valuation – Global Standards 2017* [15]

Individual appraisers are subject to the standards of the organizations to which they belong. Appraisers who hold multiple affiliations may be required to conform to the requirements of more than one set of standards. Regardless of affiliation, professional standards offer guidance that can be helpful in building a convincing case for value and upholding the basic ethical standards that preserve the public trust.

We are concerned with the application of these standards in an interdisciplinary process, where the valuation of the business entity falls within the domain of business valuation and the appraisal of the assets falls under real property appraisal. The term *appraisal* is used throughout the standards, and *valuation* is used sometimes to refer to business appraisals. For clarification, this book uses the term *appraisal* for the real estate analysis and report, and *valuation* for the business analysis and report. This section addresses key issues that are exacerbated by multiple disciplines, as well as the author's experience with issues that

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[8] Appraisal Standards Board, *Uniform Standards of Professional Appraisal Practice*, 2018–2019 Edition (Washington, DC: The Appraisal Foundation, 2018). USPAP is issued every two years.

[9] American Society of Appraisers, *ASA Business Valuation Standards* (2009). Available at: www.appraisers.org/docs/default-source/default-document-library/bv-standards.pdf?sfvrsn=2.

[10] Appraisal Institute, *Standards of Valuation Practice* (Chicago: Appraisal Institute, 2015).

[11] Appraisal Institute, *Code of Professional Ethics and Explanatory Comments* (Chicago: Appraisal Institute, 2018).

[12] National Association of Certified Valuators and Analysts, *NACVA Professional Standards* (Salt Lake City: National Association of Certified Valuators and Analysts, 2017).

[13] American Institute of Certified Public Accountants, Inc., *AICPA Code of Professional Conduct* (New York: American Institute of Certified Public Accountants, Inc., 2018).

[14] International Valuation Standards Council, *International Valuation Standards 2017*. Available at: www.ivsc.org/files/file/view/id/812.

[15] International Valuation Standards Council, *RICS Valuation – Global Standards 2017* (New York: Royal Institute of Chartered Surveyors, 2017).