

Why, How and Who of Direct Fractional Interest Valuation

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Why, How and Who of Direct Fractional Interest Valuation

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Introduction

This Paper is about real property *and also about the business of owning real property*

Here's the technical question:

What happens to the value of
one owner's interest...

when there is more than one owner?

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Introduction

Here's the professional question:

Are real property and business valuers
prepared for assignments that are...

interdisciplinary?

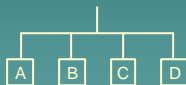
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Overview

- ◆ Individuals come together with a common goal



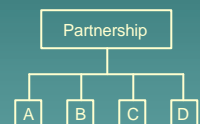
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Overview

- ◆ Form Partnership
- ◆ Pool funds
- ◆ Individuals come together with a common goal



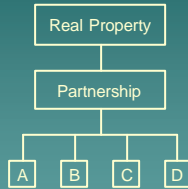
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Overview

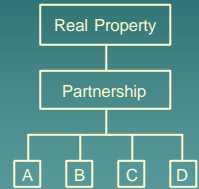
- ◆ Acquire property
- ◆ Form partnership
- ◆ Pool funds
- ◆ Individuals come together with a common goal



Overview

This diagram can represent:

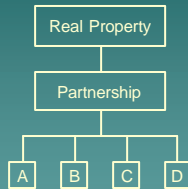
- ◆ Joint Venture develops/ holds shopping centers
- ◆ Investment partners hold property assets
- ◆ Family divides assets
- ◆ Property companies hold and manage assets



Overview

This diagram can represent

- ◆ Business of owning/ operating regulated housing project
- ◆ Also includes cotenancies (no partnership structure)
- ◆ Many more...
RP developers and investors like to "buddy-up"

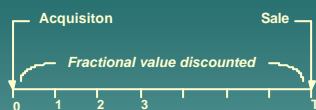


WHY?

Appraisals of fractional interests needed for:

- ◆ Tax and regulatory compliance
- ◆ Partner "divorce" / buyout
- ◆ Spousal divorce
- ◆ Apportioning family assets
- ◆ Any fractional interest valuation under *fair market value*

Value Applies for a Holding Period



During the hold, value is *discounted* because:

- ◆ The interest does not control, and risk is increased
- ◆ For private entities, risk increased further; holder cannot get out (for time T)

The Problem Is...

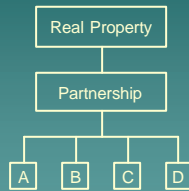
Value opinions can be contentious, since

- ◆ Fractional interests are worth less than their pro rata share of the whole, due to their reduced control and impaired liquidity
- ◆ Unfortunately, methods for such "discount" valuations are not settled—
- ◆ Required valuation process is inextricably tied to both real property and business valuation...
- ◆ But is directly confronted by neither

WHO?

Real Property Valuer →

Business Valuer →



WHO?

- ◆ The business valuer cannot value partnership / discount without understanding the real property
- ◆ The real property valuer can do a lot to assist in this process—or, the appraisal *can* be misleading or useless
- ◆ Neither valuer can do their job without a reasonable understanding of how the other does theirs

Real Property Valuer

- ◆ Values the whole real estate asset (usual approaches), but also
- ◆ Prepares an operating forecast for the property
- ◆ Develops an expression of risk (yield rate at the asset level)
- ◆ May need to provide highest and best use scenarios, growth forecasts and
- ◆ Other analysis not generally needed for a market value appraisal

Business Valuer

- ◆ Prepares forecasts for the entity based on the real property forecasts, but
- ◆ Must understand and normalize line items for *this* partnership
- ◆ Adjusts balance sheet for fair market value of real property, debt, other items
- ◆ Consider the effects of lease and real property market conditions on the business and its current owners

Business Valuer

- ◆ May need to build its rates of return on real property rates
- ◆ Concludes net asset value of partnership as a whole
- ◆ Applies market data to develop discount for lack of control
- ◆ Applies market data to develop discount for lack of marketability

Valuer Education/Training

- ◆ The real property valuation curriculum does not include the business appraiser in its process particularly ownership or capital structure
- ◆ The business valuation curriculum does not include real property
 - or markets
 - or data sources
 - or market value assumptions

Valuer Education/Training

Rather than *cross-training*, we have a cross *lack-of-understanding*, which

- ◆ May be trivial
- ◆ May produce only unconvincing arguments and client/court frustration, or
- ◆ May produce serious errors
- ◆ This lack of understanding has been causing trouble in the US for many years

Examples for Discussion

Many issues can cause appraisal problems—what if:

- ◆ Market's highest & best use is to redevelop the property, but the current owners will not redevelop?
- ◆ The partnership charges nonmarket management or other fees?
- ◆ The valued interest can cause partition, but dividing property would change its highest & best use, or reduce total value?

Examples for Discussion

- ◆ Lease terms & conditions determine a minimum holding period?
- ◆ The business appraiser's concluded yield rate has nothing to do with real property?
- ◆ How many conditions affecting real property might different owners handle differently?
- ◆ These issues can be easily compounded: i.e. Low income housing

Conclusions

- ◆ Asset holding company (including common tenancy) valuation requires both real property and business valuers
- ◆ Discounts can be large and values contentious
- ◆ Unfortunately, our profession has a lack-of-understanding problem that can produce serious errors in value

Conclusions

- ◆ I am making a plea for true cross-disciplinary training and cooperation between business and asset valuers
- ◆ The valuation community's obligation to serve the public interest requires that these issues be resolved

Thank you!

Find articles, books and seminars concerning fractional interest valuation at:

www.primusval.com

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