

## *Case Study*

### **Undivided Interest Valuation — A Case of Two Disciplines**

Valuing undivided interests in real property requires analysis from two distinct and independent disciplines: Real estate appraisal and business valuation. It is imperative that the real estate appraiser and the business valuer both understand each others' domain to some degree, and the value premise that each is working under. Each is modeling a different market, and without cross-understanding, and close consultation with the client, important property-related facts may elude their analysis. The consequences can be dramatic.

This case involves a simple property, a 100,000 square foot industrial building net-leased to a high-credit tenant, and its owner, a California general partnership. One of the partners had died, and a valuation of his interest was being prepared for the estate. The valuation process involved two appraisers: a real estate appraiser, whose concern was the leased fee value of the land and improvements, and a business valuer, whose concern was the partner's interest. This is a simple property and ownership structure, and its valuation should be a simple process—except when it's not. In this case, there were some facts that often escape scrutiny, and could have led to a wildly overstated value conclusion for the partnership interest, and an unfairly high tax burden for the estate.

#### A Simple Property

The property in question is a 100,000 square foot tilt-up concrete shell that was built in 1988 to suit its original tenant, a major telecom company, who used it as a regional data processing center. Interior improvements were largely office, including extensive computer wiring and HVAC capacity, and some warehouse usage. Technology had made much of the original tenant improvements obsolete, but the tenant consolidated operations of a nearby facility and occupied all but 18,000 square feet, which had been sublet. The current lease term ended in 1½ years, and the tenant had two 5-year options to renew. The lease rate was close to market.

Warehouse buildings were being adapted to office in this market area, and the real estate appraiser's comparable transactions were all similar buildings that were being adapted to all office, or were intended to be. Accordingly, he concluded that the adjusted \$/square foot indications were the best representation of the market. A single-period income capitalization model produced a similar conclusion, and the property was valued at \$12,500,000.

## A Simple Valuation Premise

The appraiser of the leased fee considers a typical buyer and seller, under the definition of fair market value (FMV), and the conclusion was the most probable price that would be paid in that market. The business valuer was using the net asset value (NAV) method, where all the assets and liabilities of the partnership are adjusted to their fair market values, and be included the property at its appraised value. So far, so good.

The partnership agreement and other facts and circumstances suggested that the hypothetical purchaser of the interest would end up holding it as an illiquid asset for at least five years, and maybe much longer. The partnership is not selling the property at the beginning of the period, but at the end, and the assumptions associated with a transfer at the date of value (the foundation of the real estate appraisal) may have to be revisited.

## The Big Surprise

This continued hold means that any costs associated with the property during the period would be realized, not just implied, as was the case with the market analysis. This gets us around to revisiting the lease. What if the tenant chose not to renew? Re-tenanting the building would require that the partnership essentially gut the building, as the interior improvements were dated in the first place, and include extensive raised flooring and other features suited to a wholly obsolete technology—the 1988 computer complex. The tenant had made do, but had begun subleasing unused space, and whether it would renew was entirely unknown. Additionally, the space may have to be demised to accommodate 2-3 tenants.

What would these tenant improvements (TIs) cost? A good minimum figure is \$20-\$30/square foot, but some analysts believe it could be more than \$40. This is not insignificant:  $\$25 \times 100,000 = \$2,500,000$ . On top of that, market evidence suggests that any TIs would contribute little to the leased fee value of the property; after all, rents would not increase as a result.

Here's the key test question: Would a buyer of the subject partnership interest count on lease renewal and no out-of-pocket costs associated with re-tenanting the building? Or would the buyer consider give the costs some weight (or a lot of weight) in its pricing decision. Financing the improvements is not a certain solution; the other partners liked the low debt. They were reluctant to take on more in any case, and definitely had the personal resources to put up their share.

The present value of possible TI costs had to be considered as part of the NAV analysis of the partnership. (In the year since the date of value, the partners had

indeed been accumulating funds for this purpose.) In this instance, the entire obligation was deducted. The simplified NAV balance sheet looks like this:

### Partnership Balance Sheet

	Before	After
<b>Assets</b>		
Current assets	\$49,900	\$49,900
Real property	12,500,000	12,500,000
Securities	307,700	307,700
<b>TOTAL ASSETS</b>	<b>\$12,857,600</b>	<b>\$12,857,600</b>
 <b>Liabilities and Capital</b>		
Current liabilities	\$0	\$0
Tenant Improvements	0	1,700,000
Loan balance	4,457,600	4,457,600
Owners' equity (NAV)	8,400,000	6,700,000
<b>Liabilities</b>	<b>\$12,857,600</b>	<b>\$12,857,600</b>

The loan terms are approximately market, and the only other assets are cash and a small securities portfolio (all listed). The partnership's NAV declines after adjustment by just over 20%, from \$8.4 to \$6.7 million.

#### Financing Bites

Tenant improvement risk was not the only issue facing a new partner. Existing loans are normally ignored by the real estate appraiser, since the value premise assumes a cash equivalent transaction and new financing. This is proper when valuing the 100% leased fee, but the current financing can be a major issue within the partnership, even if the property is not sold.

In this case, the nonrecourse loan was fully amortizing and carried a market interest rate, but also carried a "make-whole" premium, due if paid before maturity (14 years from the date of value). This premium is designed to protect the lender's anticipated yield, but amounted to an onerous \$770,000! Of course, the property was not actually being sold, just the subject interest; no problem, right? Wrong! The loan is only transferable at the discretion of the lender, who does not have to allow interest transfers either. The loan documents did provide that the decedent could transfer his interest within his family on his death, but that was it. (These provisions were apparently intended to preserve the creditworthiness of the borrower, even though the loan was nonrecourse.) Under these conditions, the valuer must assume that any transfer, *including transfer to the hypothetical buyer, under the definition of fair market value*, would cause the loan to be called, and trigger the make-whole payment.

So who pays? How would you feel if your partner sold his interest, which caused the lender to call the loan. Not only does the partnership have to get a new loan, but you are obligated to pay your share of the make-whole penalty—to the tune of hundreds of thousands of dollars. What happens to the buyer after he or she becomes a partner, and discovers the other partners are very unhappy about the loan situation. The reasonable solution is to charge the entire penalty to the transferring interest, leaving the other partners out of it. This requires a major reduction in value.

### Discounted Value Conclusion

The subject interest's pro rata share of partnership NAV is discounted for reason of its impaired control of the property, and its illiquidity (for at least five years following the date of value).

### **Subject Interest Value Conclusion**

		<u>Before</u>	<u>After</u>
Partnership NAV		\$8,400,000	\$6,700,000
Subject interest	75%	6,300,000	5,025,000
Less discount	26%	(1,638,000)	(1,306,500)
Discounted NAV		<u>4,662,000</u>	<u>3,718,500</u>
Less make-whole payment		0	(770,000)
Subject interest value conclusion		<u>\$4,662,000</u>	<u>\$2,948,500</u>
rounded		\$4,660,000	\$2,950,000

Unlike the NAV calculation, which is based on ongoing partnership operations (the present value of future events), the make-whole payment is cash out the door effectively at the date of value, and attributable to the interest transfer, not partnership operations. Thus, the valuer deducts the entire amount without discount.

The first adjustment, for tenant improvements, resulted in a value reduction of just over 20%. The second, for the make-whole payment, results in a further reduction of 16.5%. The value conclusion is reduced by 36.8% overall. Stated another way, ignoring these embedded facts would have overstated subject interest value by 58%! At maximum tax rates, that's a cash difference of \$942,000 to the estate.

### Conclusions

What happens when the premise on which the valuation is structured is different for the asset appraiser and business (fractional interest) valuer? Those not

accustomed to the risks inherent in property leases may assume that all there was to know was contained in the real estate appraisal, not realizing that the market behaviors, interpreted property by the appraiser, obscured critical facts.

Any fractional interest valuation, whether an asset holding corporation, partnership, joint venture, deeded interest or any other form, is a multidisciplinary assignment. Unfortunately, there is a territorial chasm between the property and business valuation disciplines, that can hide critical facts. Most often, these affect the valuer's discount analysis (for fractional interest control and liquidity impairments), and the quality of support for the conclusion. But sometimes, as we have seen, they can be very large.

The need for appraiser/client collaboration is important generally, and is essential for all assignments involving undivided property interests. Cross-education can also go a long way toward creating the understanding necessary to satisfy the client's need for a clear, well-supported opinion of value.