Real Estate Companies – A Business Valuation Primer (Series 1)

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Families and organizations that own and operate portfolios of real estate make up a significant segment of MPI's clients. We are engaged for a variety of real estate-based valuation assignments, from the simple family partnership to the large real estate organization that is engaged in development, leasing and property management activities.

Our typical client in the real estate business has a long-term "buy and hold" strategy. Therefore, most of our client relationships span several generations as ownership and, ultimately control, are passed from one generation to the next. Our larger real estate clients have come to rely upon MPI for professional continuity and the institutional knowledge and familiarity that develops over time.

The Roles of the Business Valuation Analyst and the Real Estate Appraiser

The appraisal of the underlying real estate is in the domain of a real estate appraiser. As a business valuation firm, MPI's area of expertise is in the valuation of the entities attached to a particular family or real estate organization. To remain impartial and objective, MPI does not prepare real estate appraisals. As a corollary, most independent real estate appraisers do not prepare business valuations. Time and again, trusts & estates attorneys have expressed their preference for these roles to be split. There are certain risk factors that are considered solely in the context of the real estate appraisal (e.g., geographic factors, comparable sales, etc.), and certain factors that are considered solely in the context of the business appraisal (e.g., the terms of an operating agreement, financing arrangements, distribution policy, etc.).

MPI has a network of real estate appraisers that it regularly relies upon for the underlying property appraisal work. This can be structured as a sub-contracting relationship if the client has a preference for dealing with just one valuation provider. Alternatively, some clients prefer to engage the business valuation expert and property appraiser separately.

Representative Real Estate Company Valuation Assignments

In this two-part series, we will describe certain widely-used real estate ownership structures and explain the valuation techniques that we use to derive fair market value in those cases. Series II will address freeze partnerships; tenancy-in-common interests; and service companies attached to real estate organizations.

The Holding Company that Owns and Operates the Real Estate

The Delaware LLC is the most frequent ownership structure we encounter, followed by Delaware limited partnerships. Our clients use LLCs as the ownership vessels for every property class (i.e., residential, commercial, retail, vacant land) and virtually all sizes, from a $2 million brownstone in Brooklyn to a $1 billion Class A office building.

Clients retain MPI to prepare real estate company valuations for the following purposes: estate planning and gift tax filing; estate tax filing; estate administration and distribution; partner redemptions and buyouts; partner disputes; IRS audits; estate litigation; marital dissolution; and other general advisory needs. In most cases, the subjects of our analysis are partial, non-controlling interests in the real estate entity. When dealing with a non-controlling interest, the provisions of an operating agreement or partnership agreement are critically important. Such provisions typically place restrictions upon owners of minority interests in order to centralize the management of the entity and preserve the operation of the business for the long-term. Among other things, the minority interest investor is often unable to:

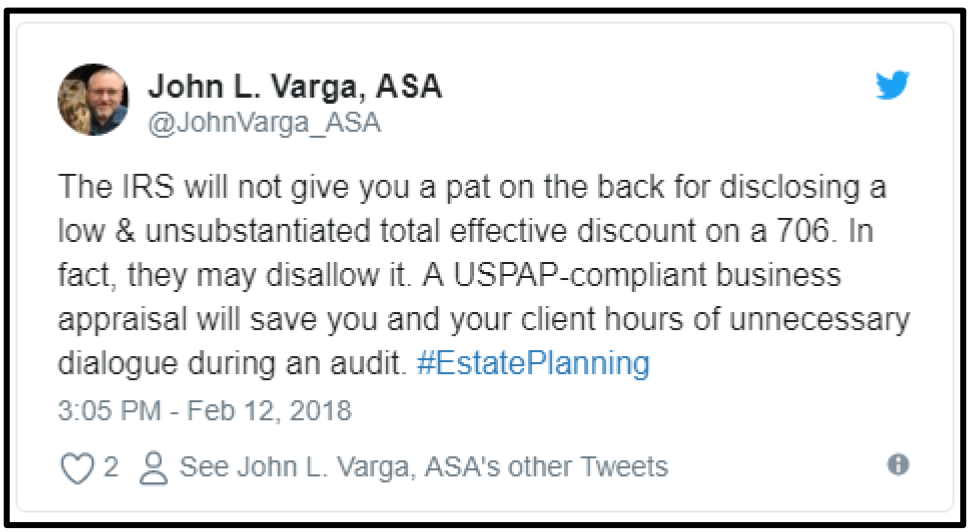
a) control the day-to-day operations of the company;
b) set the general direction and investment policy of the company;
c) borrow funds on behalf of the company;
d) hire and fire employees;
e) determine the timing and amount of distributions; and
f) sell any or all of the underlying assets of the company.

In addition to these control restrictions, governing documents often place restrictions upon the ability to withdraw capital, withdraw from the entity, and transfer ownership interests. The restriction on the ability to withdraw capital gives rise to illiquidity, in that minority interest owners have no ability to access underlying assets or demand a return of their capital. This is common in all types of private investment partnerships and is prevalent in the real estate industry.

For a Delaware LLC owning commercial or residential property, the starting point for valuation is the entity's net asset value. Net asset value is defined as the market value of the real estate plus any other assets, less liabilities. Then, we turn to the capital markets for evidence of how investors regularly price minority equity interests in real estate holding entities. Generally speaking, it is common to see transactions in real estate entities occurring at discounts from net asset value. Such discounts vary in a wide range and may be correlated to factors such as cash flow, distributions and leverage, among others. Not only does the discount reflect market realities, but it is built on the conceptual basis that investors will not pay nearly as much for an interest that lacks control over underlying assets and the entity's business affairs than an interest that has control. Minority interest discounts in the real estate sector typically range from 10% to 25% depending on the investment characteristics of the entity.

Once we have adjusted for lack of control, a second and final adjustment is considered to account for lack of liquidity and lack of marketability. This often takes the form of a discount for lack of marketability, or "DLOM." MPI develops marketability discounts using an internally-developed, peer-reviewed[1] nine-factor multiple regression model that considers over 2,000 private placement transactions spanning over 30 years. A copy of the published study may be requested here. Among several other factors, the study considers volatility and time, reflecting the correlation in the underlying data between size of discounts and the factors of volatility and holding period. Greater volatility and longer holding periods suggest larger discounts for lack of marketability are applicable.

A parting thought on the level of valuation discounts: On many occasions, we have been engaged by clients already under examination by the IRS concerning the underpayment of estimated estate or gift tax. Although an independent real estate appraisal was obtained, the taxpayer elected to provide his or her estimate of a "modest" valuation allowance to avoid controversy with the IRS (and save on business valuation fees). The punchline of this oft-occurring scenario is encapsulated in a recent tweet of mine, of which I encourage readers to re-tweet.



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The IRS will not give you a pat on the back for disclosing a low & unsubstantiated total effective discount on a 706. In fact, they may disallow it. A USPAP-compliant business appraisal will save you and your client hours of unnecessary dialogue during an audit. #EstatePlanning

3:05 PM - Feb 12, 2018

2 See John L. Varga, ASA's other Tweets

[1] Ezra Angrist, Harry Curtis, III, Daniel Kerrigan, (2011) Regression Analysis and Discounts for Lack of Marketability. Business Valuation Review: Spring 2011, Vol. 30, No. 1, pp. 36-48.

"Upper Tier" Holding Companies

Upper-tier companies provide a mechanism whereby diverse holdings in partial interests, particularly in unaffiliated real estate projects, may be centralized. We also see upper-tier companies emerge once a real estate organization has reached its third or fourth generation of ownership; the family has branched out considerably, but control is still maintained by just a few individuals in one branch.

Unlike an LLC or partnership that owns real estate directly, an upper-tier company owns a partial interest (typically minority) in another company that owns the real estate. Thus, there is an additional layer of ownership between a minority interest investor in an upper-tier company and a minority interest in the real estate holding company. The valuation methods discussed above still apply. However, an additional layer of valuation discount may be warranted.

Beyond the concept of upper-tier companies and real estate holding companies at the lower tier, certain real estate organizations may be structured with several intervening layers of ownership that emerged as the business grew, ownership diversified, and different family members had increased or decreased roles in the organization. MPI gets involved in estate tax matters where hundreds of interrelated entities with several layers of complex ownership are in place. Before we begin "crunching the numbers," we conduct an in-depth review of the organizational structure of such complex real estate organizations.

Lastly, upper-tier companies are a popular tool for structuring preferred freezes, which will be discussed in Series II.

A real estate organization is a multigenerational family enterprise that requires professionals who can navigate between the bigger picture and the underlying web of ownership. MPI has the experience to value real estate companies that range from the simple to the complex. Our studies are backed by rigorous analysis and documentation, and routinely present and defend our work to tax and judicial authorities. We invite you to contact us to discuss your valuation needs in complete confidence.

About MPI

MPI, a prestigious national consulting firm founded in 1939, specializes in business valuation, forensic accounting, litigation support and corporate advisory work. MPI provides fairness opinions, sell-side and buy-side advisory services through its investment banking affiliate MPI Securities, Inc. MPI conducts every project as if it is going to face the highest level of scrutiny, and its senior professionals have extensive experience presenting and defending work product in front of financial statement auditors, management teams, corporate boards and fiduciaries, the IRS, other government agencies, and in various courts.

For additional information pertaining to MPI or MPIS and our valuation and advisory services, visit www.mpival.com.

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