WHAT IS THE BEST PROXY FOR VALUING REAL ESTATE HOLDING COMPANIES?

When valuing a privately held real estate holding company, analysts should examine all available market data for publicly traded investments in real estate, and select the most analogous data source to apply to the subject entity.
When valuing a privately held real estate holding company, the analysis draws heavily on the net asset value (NAV) of the entity under the market approach. As stated in Rev. Rul. 59-60:

The value of the stock of a closely held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock... [A]djusted net worth should be accorded greater weight in valuing the stock of a closely held investment or real estate holding company, whether or not family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend paying capacity.²

This does not mean that an income approach should not be performed. A thoughtful, properly considered income approach is an important step to consider in any valuation. The results from the two analyses are compared and weighted, which helps lead to the final conclusion of value.

This article discusses the different sources of pricing multiple and rate of return data for real estate holding companies. The data are examined for their relevance to valuing a privately held real estate holding company. For purposes of this article it is assumed that the subject company is a closely held entity whose most significant assets are real estate of any type (e.g., commercial, residential, mixed use).

**Background**

The market approach requires the identification and analysis of sales of business interests that are comparable (i.e., similar industry, size, and degree of control.) to the subject interest, while the income approach requires the development of rates of return for comparable business interests in terms of risk, growth expectations, and financial fundamentals.

For an operating company such as a manufacturer, retailer, wholesaler, or service company, the denominator of a pricing multiple is usually either revenues (i.e., price/revenues), earnings before interest, taxes, depreciation, and amortization (EBITDA), or some other earnings metric. This does not present a problem for an operating company, where the utility of the hard assets (e.g., machinery, equipment, and computers) is derived from their usefulness in generating product or service revenue; for such a company, the hard assets are typically wasting³ assets.

For a real estate holding company, however, use of a pricing multiple derived from an income statement measurement would serve to value only the annual benefit stream of the entity, and would fail to capture the underlying value of the company’s hard assets. That is, the portion of the company’s value that resides in the real estate is not captured by an earnings-based pricing multiple. Unless the expected holding period of the real estate is extremely long, with little or no probability of an earlier sale followed by a distribution of the sales proceeds, such a pricing multiple will not fully reflect the value of the company’s real property.

**Underlying Assets.** The underlying hard assets of real estate holding companies are not wasting assets, and have significant value in their own right; the investor expects them to appreciate in value, not decline. Given the importance of the value of the under-
lying assets, a better pricing multiple for use in valuations is one in which the denominator is NAV.

Application of Market Approach. In applying the market approach to a real estate holding company, pricing multiple data would ideally be the prices of arm’s-length transactions for companies in the same marketplace as the subject. This data would be sufficiently similar to the subject company to permit valid comparisons, and measurement against NAV. For example, if a share of an entity traded at $10 at a time when the entity’s NAV was $15 per share, the pricing multiple would be 66.7% ($10/$15) of NAV. Such a pricing multiple could then be applied to the NAV of the subject interest, with appropriate adjustments, to derive an indication of value. As noted, given the importance of the value of the underlying real property, a pricing multiple based on NAV is the most relevant type of market multiple to apply.

Income Approach Rate of Return. Under the income approach, the rate of return for an operating company is typically based on the return on investment. For example, data published in Morningstar’s Stocks, Bonds, Bills, and Inflation or the Duff & Phelps Valuation Handbook are derived from total returns (e.g., dividends plus appreciation of the stock) divided by the initial investment in the stock.

Similar and Relevant
Whether using the income or the market approach to valuation, the empirical data relied on should be derived from a marketplace where business interests, similar to the subject interest, trade in arm’s-length transactions among willing buyers and sellers, from which sufficiently analogous and relevant pricing multiples and rates of return can be developed.

“Similar” refers to the nature of the business being appraised. It encompasses such business attributes as:

• Business size.
• Markets served.
• Depth of management.
• Information processing systems.
• Level of technology utilization.
• Probable future earnings growth.

“Relevant” refers to the desires and expectations of the probable “willing buyer” or investor. This includes:

• Risk tolerance (degree of risk assumed).
• Investment liquidity.
• Degree of management involvement.
• Probable holding period.

Data Sources
Possible sources of rate of return data or market pricing multiples from real estate holding companies include the following:

1. Publicly and actively traded real estate investment trusts (REITs).
2. Closed-end real estate funds (CEFs), (which invest in REITs), and are publicly and actively traded.
3. Real estate limited partnerships (RELPs), which are traded infrequently on a secondary market.

Not all of these sources are equally appropriate in the valuation of a closely held real estate holding entity.

Income Approach. As stated above, the rate of return for an operating company is typically based on the return on investment. This can also be true for publicly traded real estate holding companies, whose returns are based on both dividends and appreciation of the stock. Analysts and investors price REITs and CEFs just like stocks, the major difference being that funds from operations (FFO) is substituted for earnings per share in the analysis. The
National Association of Real Estate Investment Trusts (NAREIT) defines FFO as “net income (computed in accordance with GAAP) excluding gains or losses from sales of most property and depreciation of real estate.”

**REIT and CEF Returns Only Include Stock Appreciation.** However, it must be noted that the returns include appreciation of the stock, not the real estate; although changes in the stock price might include the marketplace’s consideration of changes in real estate values, there is not a direct link. Like stocks of other companies, stocks of REITs and CEFs trade based on the marketplace’s consensus estimate of future dividends and appreciation in stock value, as well as an assessment of risk. Among the factors considered by stock analysts who follow REITs are:

- Cash flow.
- Projected growth in cash flow.
- Vacancy rates.
- Lease renewals.
- Growth in the value of underlying properties.
- Size.
- Degree of financing.
- Access to capital markets.
- Diversification.
- Overall risk.

**Adjustments.** As always when using guideline public company data, the analyst must consider appropriate adjustments to the observed rate of return for differences between the publicly held companies and the subject. That is, the valuation analyst must understand how the stock analysts’ assessment of various growth, market, and risk factors differ from those of the subject company, and adjust the resulting rate of return up or down accordingly.

It is likely that there are significant differences between how the factors listed above apply to REITs and to privately held real estate holding companies. Each layer of difference, between the public companies and the subject interest, introduces the need for the valuation analyst to apply a series of subjective adjustments to the observed rate of return before applying the income approach. Ideally however, the companies from which the empirical data is drawn will resemble the subject interest as closely as possible, minimizing the need for such adjustments.

Additionally, appraisers must keep in mind that an income approach analysis that is not directly related to the value of the underlying assets may in itself be a step or two removed from Rev. Rul. 59-60’s guidance to accord greater weight to adjusted net worth than to earnings measures.

What follows is a description of the data sources for publicly traded entities that invest in real estate, to facilitate the analyst’s assessment of their comparability to a subject privately held real estate holding company. From this information, analysts can assess the relevance and applicability of the data in the valuation of the subject real estate holding company.

**REITs**

One choice for empirical data is the marketplace for REITs. Because REITs invest in real estate, and non-controlling interests in them are actively traded, they are sometimes looked to as proxies for valuing a privately held holding company with real estate assets. However, the analyst must consider if the selected REITs are truly comparable to the subject interest.

**Background.** REITs are classified as either equity REITs or mortgage REITs. Equity REITs derive most of their revenue from rent; mortgage REITs derive most of their revenue from interest earned on their investments in mortgages or mortgage-backed securities. This discussion will focus on equity REITs, which comprise 90% of listed REITs, since they are more relevant to the majority of the subject entities that are typically valued.

To qualify as a REIT, the entity must, among other requirements:

- Invest at least 75% of its total assets in real estate.
- Derive at least 75% of its gross income from rents from real property, interest on mortgages, or sales of real estate.
- Pay at least 90% of its taxable income in the form of shareholder dividends each year (as a result, REITs generally do not retain their earnings).

Some of the characteristics of REITs include diversification (equity REITs invest in many different property types in all 50 states), regularity of dividends, liquidity (more than 160 REITs are traded on major stock exchanges), and transparency (publicly traded REITs operate under the same rules as other public companies for securities regulatory and financial reporting purposes).

Since REITs are publicly traded there is much data available, including their returns over the years; this information is reported by the National Association of Real Estate Investment Trusts (www.reit.com).

**Comparison to Closely Held Real Estate Entities.** Some of the characteristics of REITs that are similar to those of a typical privately held real estate holding company include investment in, and income from, real estate. In addition, REITs pay at least 90% of their taxable income in the form of shareholder dividends each year, and although the typical privately held company does not have this as a stated requirement, distribution of most, if not all, available cash flow is often assumed in the valuation process.

However, there are a number of ways in which REITs differ from the typical subject privately held real estate holding company. For example, REITs are managed by independent boards of directors or trustees, and have no more than 50% of their shares held by five or fewer individuals. Because of the large amount of equity raised by REITs, they typically own very large portfolios of institutional-grade properties that are well diversified in terms of geographical markets and tenants.

REITs also typically have much greater access to capital, both debt and equity, and are growth-oriented entities, meaning they expect to continually improve the real estate portfolio. They are actively followed by many full-time analysts and investors, and have full
time officers and employees who are
devoted to managing day-to-day affairs.

The valuation analyst must carefull-
ly weigh both the similarities and dif-
fences in order to properly apply
public company REIT data to the sub-
ject interest. These differences do not
preclude use of REITs as proxies for
valuation purposes. However, as dis-
cussed above, the analyst must make
(and support the reasons for) appro-
priate adjustments to the market rate of
return, in order to bridge the gap
between the two types of entities in a
meaningful way.

**Closed-End Real Estate Funds**

CEFs are another possible source of
market data for real estate holding
companies. These are defined by the
Closed-End Fund Association (CEFA) as
funds that invest primarily in equi-
ty securities of domestic and foreign
companies engaged in the real estate
industry. As with REITs, CEFs are usu-
ally much larger than the typical close-
ly held real estate holding company.

For example, the Cohen & Steers
Quality Income Realty Fund, Inc. (tick-
er symbol: RQI) had a NAV of $1.1
billion at the end of 2013. Its single
largest holding, at $149 million and
9.2% of total assets, was in shares of
Simon Property Group. About 82% of
its holdings are in equities of real estate
companies such as Simon Property
Group, Vornado Realty Trust, and Pub-
llic Storage, with the remainder in pre-
ferred shares and bonds of REITs and
other investments. Another fund,
Nuveen Real Estate Income Fund (tick-
er symbol: JRS) had total assets of $395
million at the end of 2013, 60.2% of
which were in REIT common stocks
and 36.9% in REIT preferred stocks,
with a NAV of $275 million.

Because they are publicly traded,
much financial information is avail-
able for CEFs, including their NAV and
the discount (from NAV) at which their
shares trade. However, because they
may invest in the securities of REITs,
the same comments and cautions dis-
cussed above regarding the applicabil-
ity of REITs in applying the income
approach are also applicable to CEFs,
but even more so because the REITs
are owned inside a CEF.

The income reported by CEFs rep-
resents dividends and interest from,
and gains or losses on, the investments
held by the fund. Hence, the rate of
return information reported for a CEF
is based on income that is fundamen-
tally different from the rental income
stream received by a closely held real
estate entity. In addition, the base on
which the return is computed is the
value of the shares owned by the fund,
not the value of the underlying real
estate owned by the company whose
shares are owned by the fund.

**Real Estate Limited Partnerships**

RELPs were formed in order to pool
funds and invest in real estate prop-
erties around the U.S. Originally, inter-
ests in RELPs were not intended to be
traded. Over time, however, an infor-
mal secondary market evolved to match
sellers with buyers. Thus, such interests
have come to be traded. RELPs announce
their NAVs on an annual basis and make
other public disclosures, such as their
amount of interest-bearing
debt, quarterly distributions, and
information regarding trades of non-
controlling interests in the partnerships.
Partnership Profiles Inc. (PPI) publishes data on the prices at which the partnerships’ interests trade on the secondary market, and from this data, pricing multiples in the form of price-to-NAV ratios are published.

These partnerships are typically much smaller than REITs. For example, the 77 RELPs in the PPI database for 2013 (that had not announced plans to liquidate) had a median NAV of $26.5 million and 13 properties. This is still larger than the typical privately held real estate holding company, but much closer to them than to REITs.

PPI conducts an annual study to determine the estimated annual rate of return expected by investors purchasing non-controlling interests of publicly held real estate partnerships in the limited partnership secondary market. The authors of the study calculate expected rates of return by applying a series of assumptions likely to be applied by marketplace participants such as forecasts of future distributions, cash flow from amortization of debt, capital appreciation of real estate, and a presumed liquidation event. Thus, it is key that the market multiple should be applied to fund- in the proper use of the market approach.

The Market Approach
When applying the market approach, in addition to identifying a sufficient number of transactions the analyst also must assure that, to be meaningful, the transactions involve sufficiently comparable companies, as determined by size, leverage, and other financial and nonfinancial metrics. Equally important in the proper use of the market approach is assurance that the market multiple and the subject company metric are analogous:

If a valuation multiple is computed based on guideline company data defined in a certain way, that multiple should be applied to fundamental data defined the same way for the subject company.8

Thus, it is key that the market multiple and the subject company metric to which it is being applied are analogous. Otherwise, the price of apples is being used to estimate the value of an orange.

In valuing operating companies using the market approach, comparables are typically found in one or more of several private company transaction databases, including Pratt’s Stats, Bizcomps, and the database of the Institute of Business Appraisers, as well as the universe of public companies. But for real estate holding companies, there are different choices, and not all of them are equally desirable for the intended purpose of applying the market approach to a small, privately held real estate holding company.

REITs. REITs are typically priced based on funds from operations, a measure of cash flow. This is a price-to-earnings multiple, not a price-to-NAV multiple. As stated earlier, a multiple based on an annual benefit stream does not capture the value inherent in the underlying assets. REITs do not typically report the market value of the underlying properties they own. Since the market values of the properties owned by, for example, Simon or Public Storage, are not known, neither are their NAVs known. Thus it is simply not possible to derive a pricing multiple for these REITs as a percentage of their NAV. Hence, REIT prices are not based on the NAVs of the underlying properties, so that pricing multiples based on NAV cannot be determined.

Closed-End Funds. Unlike REITs, CEFs do report their shares’ trading prices as a percentage of NAV, from which a discount from NAV can be computed. While this information is useful to the invest-
The analyst will have to consider appropriate adjustments, up or down, to the market-based pricing multiples to account for any differences between the publicly traded RELPs and the subject company before concluding a value. However the market data from the secondary RELP market are directly analogous to the typical closely held real estate holding company. It also represents a close link to the adjusted net worth of the real estate holding company, as contemplated by Rev. Rul. 59-60.

Accordingly, the pricing multiple data reported by PPI for RELPs that trade in the secondary market is directly analogous and applicable to privately held real estate holding companies with proper adjustments, and in keeping with the Rev. Rul. 59-60’s guidance. The data available from REITs and CEFs, however, are not directly analogous, and are less useful in the application of the market approach.

Conclusion
Data is available for three types of entities that invest, either directly or indirectly, in real estate:
1. Real estate investment trusts (REITs).
2. Closed-end real estate funds (CEFs).
3. Real estate limited partnerships (RELPs).

In applying either the income approach or the market approach, valuation analysts must attempt to use data that is most analogous to the subject company. The analyst must appropriately adjust for differences between the companies that make up the empirical data and the subject company, as well as considering how the data is constructed and what it purports to measure.

An examination of the three sources of data shows that RELPs bear a much closer resemblance to the typical privately held real estate holding company than do either REITs or CEFs. Rates of return and pricing multiples of RELPs are thus better proxies for use in valuing such an entity. While this does not rule out consideration of REITs and CEFs, their use requires a greater degree of subjective adjustment in order to be applicable.