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Analyzing Business Appraisal Discounts Applied to a Real Estate Entity

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Among the many types of investment assets that may be owned in a marital estate or a decedent's estate are ownership interests in privately held businesses. Such interests may be in an operating company such as a wholesaler, retailer, manufacturer or a service company. The interest may also be in a real estate entity that could own commercial, industrial or residential properties (either multi-family apartment buildings or single-family houses) or agricultural or vacant land.

Since the asset is privately held and not actively or even thinly traded on any recognized exchange, this presents a number of hurdles to determining the value of the asset for inclusion in an individual's net worth statement, gross estate or the amount of a gift. Accounting standards differentiate between assets that are easily valued by reference to quoted market prices or other data that is observable in the investment marketplace and those assets that must be based on "unobservable" inputs.[1]

This article focuses on those assets that must be valued by reference to unobservable inputs, i.e., those assignments that typically require the services of an independent, qualified business appraiser. The subject interest is also assumed to be a non-controlling interest, and, obviously, a non-marketable interest.

It is important to remember that what is being valued is the ownership interest in the business, not the assets owned by the business, either individually or as a group. That is, the owner of shares[2] of XYZ Company, a commercial printer, does not own a pro rata portion of XYZ Company's cash, fixed assets, inventory and any other assets. These are assets of the company. Nor does the shareholder have any personal obligation to pay the company's liabilities barring, of course, any personal guarantees.

Even in the case where there is a personal guarantee to pay the company's liabilities, this is a personal obligation, and is not connected to ownership of the shares. The hypothetical buyer of the shares does not, automatically, become personally obligated on these liabilities. There would have to be a separate arrangement agreed to by the lender and the new owner of the shares.

Similarly, the owner of an interest in ABC Realty, a real estate entity owning a 35-unit apartment building, does not have any direct ownership in the company's cash, real property or other assets, nor does she have any obligation to pay the mortgage or other liabilities, again barring any personal guarantees.

This is a critical distinction, because it is a foundation for the valuation analysis that is applied, and is the basis for the valuation discounts taken. Such discounts are typically a discount for lack of control and a discount for lack of marketability, either of which, or none of which, may apply, depending on the circumstances. A discount for lack of control may apply where the subject interest lacks the power of control, and a discount for lack of marketability may apply where the subject interest lacks marketability. However, the applicability of any discount is contingent on the valuation method(s) applied. For example, certain data that a business appraiser would use under the Market Approach[3] consists of sales of non-marketable interests. Since the subject interest is non-marketable, apples are already being compared to apples, and a discount for lack of marketability is "baked into" the analysis. Thus, a separate, discrete discount for lack of marketability would be duplicative. Therefore, for a discrete business valuation premium or discount to be appropriate, the method(s) used and the subject interest must have different control or marketability characteristics.

The real estate appraisal is a necessary starting point for the business appraiser who is valuing an interest in the entity that owns the real property. It is therefore important to understand how a real estate appraiser analyzes and values a real estate property, and how that differs from how a business appraiser would analyze and value a non-controlling interest in the company that owns that property. With an understanding of these fundamental differences, the user of the business appraisal (the Internal Revenue Service, a litigant or

judge) can better understand why the valuation discounts are appropriate.

Real Estate Appraiser's Property Analysis

Rights of Ownership. The real estate appraiser[4] is typically asked to value a 100 percent interest in the real estate, unencumbered by any limitations on control or marketability, subject, perhaps, only to the rights to occupy the property that have been temporarily assigned to lessees of the property. In some cases the real estate appraiser values a leased fee interest, "where the possessory interest has been granted to another party by creation of a landlord-tenant relationship." Alternatively, the real estate appraiser may value a fee simple estate, with "absolute and unqualified rights of property possession, use, disposition, transfer, and sale, unencumbered by any other interest or estate."[5]

The owner of a non-controlling interest in ABC Realty has no such rights to the property; the only rights owned by such an owner are those permitted by the business code of the relevant state or the entity's operating agreement, i.e., voting rights, liquidation rights, rights to distributions, etc. This is quite a different bundle of rights than those being appraised by the real estate appraiser.

With this in mind, the real estate appraiser typically applies two different approaches to value. Under the Income Approach, the appraiser determines the present value of the future cash flows to be generated by the property. The cash flows are discounted to a present value using an appropriate rate of return. In addition, the appraiser may use the Market Approach, wherein the appraiser values the subject property by reference to the selling prices of other, similar, properties, with appropriate adjustments.

It should be noted that the business appraiser uses the same approaches, but applies analyses and empirical data that are entirely different from that used by the real estate appraiser.

Discount for Lack of Control: The Income Approach. Because the real estate appraiser is valuing a controlling ownership interest in the property, she develops a rate of return that is appropriate for a controlling interest in real estate. This is usually developed by blending an estimated rate of return for a lender (a mortgage rate) and an estimated rate of return for equity (the owner of the property). The mortgage, usually of 75 to 80 percent of the value of the underlying real estate, is invariably secured by the property, and the equity rate of return is based on 100 percent, controlling ownership of the property. In contrast, the rate of return for a non-controlling interest in ABC Realty is neither secured by any hard asset, nor does it have control over the entity.

In recent real estate appraisals reviewed by the author, such blended rates of return have ranged from approximately 5 percent to approximately 10 percent. Naturally, the precise blended rate of return in any particular case relies in large part on the characteristics of the property, as well as economic and industry conditions prevailing at the time.

In contrast, the rate of return used by a business appraiser to value a non-controlling interest in ABC Realty is based on the rates of return observed in the investing marketplace for non-controlling interests in similar entities to ABC. Such empirical data is published by Partnership Profiles, Inc. (PPI).[6] The rates of return developed, relying in part on data published by PPI for non-controlling interests in entities that own real estate, have ranged between 17 and 22 percent in recent years, depending on a number of factors related both to the characteristics of the property and the economy. If, for example, the real estate appraiser uses a rate of return of 9 percent and the business appraiser uses 18 percent, this implies a discount for lack of control of 50 percent.

The disparity between the range of returns used by the real estate appraiser and the range of returns used by the business appraiser is primarily because the real estate appraiser is relying on rates of return related to 100 percent ownership of the property, whereas the business appraiser is using rates of return for non-controlling interests in real estate entities. The higher rate of return is intended to capture the additional risks assumed by the investor in a non-controlling interest in an entity that owns real estate as compared to direct ownership of the real estate. Accordingly, this differential translates into a discount for lack of control, which is "baked into" the analysis, and does not require a discrete discount for lack of control.

Discount for Lack of Control: The Market Approach. The real estate appraiser often applies a Market Approach in addition to an Income Approach, wherein she values the subject property by reference to the prices for which other, similar properties have sold. By definition, then, the buyers of these similar properties acquired the entire parcel of real estate, a 100 percent controlling interest. Accordingly, the real estate appraiser's conclusion is for a controlling interest in the subject property.

The business appraiser, however, is valuing a non-controlling interest in an entity that owns real estate, and so applies the Market Approach by looking to empirical data for the sale of non-controlling interests in real estate entities. PPI publishes data on the pricing multiples paid in exchange for non-controlling interests in real estate entities, in arm's length transactions. For example, such a non-controlling interest may trade for 80 percent of the company's net asset value.[7] By definition, the real estate appraiser has valued the interest at 100 percent of net asset value.

In this example, the discount for lack of control is 20 percent.[8]

Discount for Lack of Marketability (DLOM). Real estate appraisers typically assume a six to 12 month marketing period, and only in circumstances in which the property cannot be sold within 12 months do they consider reducing the value due to impaired marketability. Thus, except in unusual circumstances, the real estate appraiser's opinion of value does not include any DLOM of the real property.

In contrast, a non-controlling interest in a closely held company that owns real estate suffers from a significant degree of impaired marketability, resulting in a diminution in value to compensate the hypothetical buyer for accepting the additional risk that comes with an inability to sell the asset quickly.

One recognized authority states "there is considerable evidence … suggesting that the marketability discount for a closely held stock …should average between 35 and 50 percent, in the absence of special circumstances …"[9] Thus, the business appraiser begins with the entity's net asset value, determined using the value of the underlying real estate, based on (1) a rate of return for a controlling interest, and (2) the selling prices of controlling interests in similar properties. The business appraiser must then apply appropriate valuation discounts in order to convert a value for a controlling interest in marketable real estate into a value for a non-controlling and non-marketable interest in an entity that owns real estate.

As seen above, a discount for lack of control can be 20 percent or more, and the discount for lack of marketability can be 35 percent or more, so that the value of the non-controlling interest in the entity may ultimately approximate 50 percent of the entity's net asset value.[10]

The combination of these factors is the reason why the value of a non-controlling interest in a real estate entity is worth less, perhaps considerably less than the pro rata value of the entity's underlying assets.

Endnotes:

1. Statement of Financial Accounting Standards (FAS) 157 "Fair Value Measurements," Financial Accounting Foundation, 2010.
2. This article discusses shares in a company, which can be interpreted as units in a limited liability company or a partnership, or an ownership interest in any other entity type.
3. The Market Approach estimates value by reference to what similar investments have been sold for in arm's length transactions.
4. The author is not a qualified real estate appraiser; these comments come from many years of reviewing real estate appraisal reports in the context of valuing non-controlling interests in the entities that own the properties.
5. These definitions are from real estate appraisals we have used; the real estate appraisers, in turn, cited "The Dictionary of Real Estate Appraisal—Fifth Edition."
6. Some business appraisers use rates of return on real estate investment trusts or closed end funds that invest in real estate. However, these are not appropriate for valuing the type of entity discussed in this article. See Russell T. Glazer, "What is the Best Proxy for Valuing Real Estate Holding Companies?," Valuation Strategies, published by Thompson Reuters, January/February 2015.
7. Net asset value is the market value of the entity's assets (which may include cash and other assets in addition to the RE) less the market value of its liabilities.
8. This is a hypothetical example, but is well within the range of where the actual discount for lack of control may ultimately be.
9. Fishman, Jay E., Shannon Pratt, J. Clifford Griffith, D. Keith Wilson, "Guide to Business Valuations" Practitioners Publishing Company, 2007, §803.55.
10. Note that the discount percentages are not added to one another, but rather are applied in sequence.

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