REIT OR WRONG: USING REIT DATA TO VALUE PRIVATELY HELD REAL ESTATE PARTNERSHIPS

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When valuing private entities with significant real estate holdings, whether family limited partnerships (FLPs), real estate limited partnerships (RELPs), or other ownership forms (such as LLCs), there comes a time in the assignment when adjustments for lack of control or marketability must be considered. At this point, the valuation professional will seek to quantify the adjustments based on the most reliable and relevant empirical data available. In the not too distant past, nearly everybody appeared satisfied with data from the secondary market for RELPs.[1] After all, they are partnerships invested in real estate. Good data is available and affordable. Price-to-net-asset value (NAV) for various property types, debt levels, and yields are presented to facilitate comparison to a subject partnership. It is unknown how much of the discount from NAV reflected in the data relates to lack of control and how much relates to lack of marketability, but there are strategies to address that.

However, some valuation professionals became concerned when, over the past few years, the number of partnerships dwindled due to liquidations. Less data, it was feared, meant less reliability. Another complication was that announced liquidity horizons resulted in lower discounts than in prior years' surveys. To obtain data that was more representative of privately held partnerships, some valuation professionals based their analysis on older surveys. This could create the appearance of "shopping" for data to support greater discounts. All of this motivated some valuation professionals to seek an alternate source of empirical data to help quantify their discounts.

REITs

Real estate investment trusts (REITs) provide an interesting alternative to the secondary market for RELPs. They are invested in real estate. They are numerous, with no impending signs of extinction. They are publicly traded and accordingly subject to a great deal of disclosure. Statistics exist regarding the relationship between their trading prices and their NAV. Because REITs are publicly traded, any discount from NAV that they experience is due exclusively to lack of control; therefore, any applicable discount for lack of marketability has to be quantified separately.

There is a further complication. Many REITs trade at a *premium* to NAV. For an illustration of the challenges this causes, see *McCord*[2] and *Lappo*,[3] and this author's previous article on the subject.[4] In these two cases, the Service's experts explained that a REIT's price-to-NAV relationship is the function of a lack-of-control discount and a liquidity premium. The liquidity premium arises from the investor's ability to have a liquid minority investment in an otherwise nonliquid asset (real estate). Therefore, the expert must first quantify, then reverse the effects of the liquidity premium in order to estimate the discount for lack of control inherent in the REIT interest. Once that is done, the valuation professional has to consider and quantify a marketability discount separately, because the NAV of the privately held RELP certainly would not trade at a liquidity premium. In summary, the valuation professional has to go through three stages of adjustment:

1. Quantify and reverse the REIT's liquidity premium.
2. Apply the now-isolated lack-of-control discount to the subject interest.
3. Quantify and apply a marketability discount to the subject interest.

It is a complex process involving multiple interdependent estimates, requiring reliable data and judgment. One has to ask: Does this additional complexity result in additional accuracy? Valuation professionals must answer this question on their own.

In choosing whether or not to use REITs as the guideline for minority interest discounts, the cost of obtaining data might be a consideration. Some sources are modestly priced ($400 to $500 annually), but limited in terms of data. One source cited by the experts in *McCord* and *Lappo* costs about $10,000 per year. This is not a resource for dabblers. A question again arises: Is the incremental cost justified by an incremental degree of accuracy? Before trying to answer that question, the nature of REITs should perhaps be considered.

At this point it is useful to contrast REITs with RELPs. Rather than go

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through a direct side-by-side comparison, it is assumed that the reader has a comfortable knowledge of RELPs and all that is needed here is a discussion of REIT attributes.

First, what are the similarities of REITs to RELPs?

- *Heavily invested in real estate*—At least 75% of a REIT's total assets are required to be in real estate.
- *Passive investment*—The REIT shareholder has no involvement with the management or operation of the underlying real estate.
- *Access*—REITs provide an opportunity for the small investor to participate in the real estate sector.

What are the differences?

- *Marketable*—REIT shares are publicly traded equity securities listed on the New York Stock Exchange and NASDAQ. As such, they are completely marketable. The trading prices of REIT shares are reported every day in the financial press. An investor can own as little as one share in a REIT.
- *Regulation and Governance*—REITs are subject to the same SEC regulation and oversight as other publicly traded companies. They have corporate governance structures similar to large corporations. The directors are elected by, and serve at the pleasure of, the shareholders. REITs are professionally managed.
- *Financial transparency*—Any REIT can be looked up on EDGAR to review its audited annual financial statements and quarterly reports. REITs follow generally accepted accounting principles (GAAP).
- *Investment grade*—REITs are considered suitable investments for IRAs, 401(k)s, and other pension plans.
- *No pass-through*—A REIT shareholder cannot be called on to contribute more capital to the REIT and operating losses cannot be passed through to the owners.
- *Distributions*—One of the unique and probably most attractive features of REITs is their distribution requirement. REITs must distribute at least 90% of their annual taxable income to shareholders in order to escape entity-level taxation. Accordingly, REITs have relatively high yields.

Clearly, there are more differences between REITs and RELPs than similarities. In fact, the only compelling similarity is the underlying investment in real estate. Of course, it is this common denominator motivating the analysis in the first place.

Application of the Data

Next one must examine how the REIT data is used. One manner was illustrated in *McCord* and *Lappo.* The discount to the NAV percentage is derived and treated as the discount for lack of control. In other words, the REIT data is used just as the data from the secondary market for limited partnerships would be used. The difference, as discussed above, is that a marketability discount will have to be derived as a separate step.

However, is a REIT's price-to-NAV ratio representative for RELP purposes? The multi-stage process of separating out the liquidity premium has already been discussed. The numerous structural and operational differences have been pointed out as well. What about the NAV itself? How reliable is it? To determine the NAV of a private RELP, a valuation analyst will almost certainly obtain a competent real estate appraisal. The NAVs of RELPs in the secondary market data are sometimes based on appraisals and sometimes estimated by the general partner. How are the REIT NAVs determined?

1 *The Partnership Spectrum* (Partnership Profiles Inc.).

2 120 TC 358 (2003).

3 TCM 2003-258.

4 Israel, "A Trio of Family Limited Partnership Cases: What Can Be Learned from *McCord, Lappo,* and *Peracchio*?," 7 Val. Strat. 12 (January/February 2004).

5 Gering, "An Inexact Science," NAREIT Real Estate Portfolio (November/December 2002).

Source of NAV

It may be surprising to learn that the REIT NAVs are estimated by market analysts. The analysts obtain descriptions of the properties from REIT literature and apply some long-distance appraisal theory. They review available information regarding rent, operating expense, vacancy, location, and physical condition, and then estimate property values by capitalizing income.

The resulting NAVs can vary significantly. In an excellent article on the subject in NAREIT Real Estate Portfolio,[5] Art Gering presents a matrix reflecting the NAV per share of ten REITs published by four different securities firms in the third quarter of 2002. While some of the values were tightly grouped, some varied greatly. On average the highest cited value for a REIT was 16.27% greater than the lowest cited value. In two cases, the highest were more than 33% greater than the lowest. This poses serious implications to valuation professionals using the data to value privately held RELPs. Because it cannot be assumed that experts will subscribe to four or more data sources, picking the "right" one could prove critical. However, there is an even more intriguing variable in the published NAV estimates.

Franchise Value

According to Gering, many of the analysts include "franchise value" in their NAVs. They are vague about its specifics and quantification, but insist that it is essential to include it. There are a number of notions among the analysts as to the nature of franchise value. The quality of the management team appears to be a common denominator. Some organizations consistently manage their REITs in a more profitable way, and the analysts want to capture the value that this creates for the shareholder. Described in that way, it certainly appears that goodwill is included in some of the analysts' NAVs. They would probably object to the goodwill characterization, but it is safe to say they are including an intangible. Whatever it is called, it must be emphasized that no such "asset" is included in the NAVs of privately held RELPs. This is an apples-to-oranges comparison.

Other REIT Methodologies

This author is of the opinion that using price-to-NAV data from REITs in the valuation of privately held RELPs is inappropriate, but there are other ways to use REIT data.

There are a number of other financial statistics published regarding REITs. One is funds from operations (FFO). FFO is generally described as net income plus depreciation and amortization, and excludes gains or losses from property sales. It is a measure of cash flow from operating the REIT's properties. Some valuation professionals have had success by determining the price-to-FFO ratio of REITs that are holding properties comparable to the subject RELPs, and then applying that ratio to the subject's FFO. This process bypasses NAV altogether. If it is applied to a subject's non-control FFO, it should result in a minority interest value, obviating the need to quantify a minority interest discount separately. The only problem is the inconsistent FFO of many privately held RELPs. This can be overcome with good analysis and normalization of the subject's FFO if appropriate.

REIT yield data is also available. Some valuation professionals have applied REIT price-to-yield ratios to the distribution stream of private RELPs. There are many instances in which this methodology will not work. Remember, REITs must distribute at least 90% of their annual taxable income. Many privately held RELPs seldom if ever make distributions. Some may distribute only enough to pay the taxes arising from income passed through to the partners.

At this author's firm, appraisers have been using REIT takeover data to help value minority interests in private RELPs. Based on the median premium paid over the market share price in selected REIT takeover transactions, the inferred minority interest discount can be calculated. That minority interest discount is then applied to the NAV of the subject RELP.

Conclusion

There are major structural and operational differences between REITs and privately held RELPs. There are significant inconsistencies in the manner in which the published net asset values of REITs are estimated. For these reasons, this author suggests that using the NAVs of REITs to value privately held RELPs is inappropriate. While acknowledging that not all valuation professionals will share this opinion, the author recommends that REIT data be used only with a thorough understanding of its strengths and weaknesses, and with the exercise of appropriate caution.

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