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The Partnership Needs Working Capital. Say What?

Business operations need working capital. This well-known fact is normally considered when valuing going concerns. But (as is often the case) the entire idea evaporates when the business is holding real estate. Why? The short answer is that multidisciplinary valuations generate blind spots. Consequently, value conclusions for interests in real estate holding companies can be very unrealistic. The solution is to simply regard holding and operating real estate as a business (because it is), and give working capital the same consideration that it receives in a business valuation. Nothing new here. Except when there is, because…multidisciplinary blind spots.

First, the balance sheet

Working capital is defined as current assets less current liabilities. It can sometimes be complicated if inventories, receivables, payables and other short-term obligations are involved. Fortunately, a real estate holding company's balance sheet is typically simple, with working capital consisting mostly of cash and cash equivalents. For the sake of illustration, let's consider working capital to be cash.

Valuers routinely project the balance sheet in their income analyses, which usually means growing working capital to match growing revenues (otherwise growth is free), covering future capital expenditures (CapEx), considering foreseeable risks, and more. There are lots of variations based on industry sector. So far, so good.

Shining a light on some blind spots

Once the business is holding and operating real estate, though, any concern for what the balance sheet looks like over time is often lost. Why? Because real estate is in a different valuation domain, generating blind spots. But it only takes a little reflection on holding and operating real estate for one to realize that cash reserves are indeed required. The amount can vary widely based on the property type, from near-zero to millions. Here are some possible scenarios:

1. A long-term net lease with a credit tenant has many years left on the lease and extensions that are almost certain to be exercised. The owners receive periodic rent checks. These go into a bank account and are distributed. That’s it, so there's not much cash needed. A near-zero cash balance is fine.

2. The same tenant as above has a lease that terminates in the near term, and it is clear from real estate market analysis that the tenant will not renew. Perhaps the improvements are functionally obsolete, and the owners would have to build out the space to suit a new highest & best use. The owners know this, and have been accumulating cash because they will need a lot (millions some-times) for capital improvements. A $1 million bank account, say, might be en-tirely inadequate, and the partners might continue to see very low distributions for years.

3. A multi-tenant commercial or residential property may have significant tenant turnover, requiring periodic injections of cash to prepare the spaces for new tenants. The need for cash is ongoing.

4. A multi-tenant office or retail property, particularly one with older improvements, might be facing potential tenant loss to newly constructed buildings nearby. This may require both absorbing rent loss to vacancy and re-tenanting expenditures. Add in a heavy dose of uncertainty, and prudent owners would need to have cash on hand; maybe a lot.

5. A partnership owns several properties and has recently sold one. They have $5 million in cash. They intend to buy another property but have not yet identi-fied it. For a noncontrolling partner, does this amount represent risk-free cash, or an as-yet unknown asset which, in reality, might pose uncertainty risk on top of asset risk?

6. The partners could also be sitting on way more cash than their business operations need. While that may make the partners happy, the valuer still has to account for it in some reasonable way.

How cash requirements stay hidden

Cash requirements are real and must be considered in the valuation. But first they must be known. Valuers typically rely on the real estate appraisal for this, but (here comes the blind spot) the real estate appraiser is not valuing the balance sheet. Just the asset. Future capital requirements might be considered by deducting an annual reserve, or with specific line items. A discounted cash flow might consider re-tenanting costs on turnover (lost rent, tenant improvements and commissions). But it is also possible that such costs might be partly or entirely ignored if the appraiser relies on market data that also includes similar costs. *The real estate appraisal is prepared assuming the entire property transfers and it is operated in a way that is typical for its market.* Valuing a partnership, by contrast, considers actual operations during a holding period, and market operation only at the end of the period (an assumed sale/reversion). The rest of the balance sheet must be accounted for during that period, including actual cash needs.

As is clear from the enumerated scenarios above, a partnership's cash needs must be considered, along with debt service and all other balance sheet items. Just like a business. Because it *is* a business. So, what is a valuer to do?

Steps to accounting for working capital in the valuation

First, determine the reasonable capital requirements of the specific property. Talk to the client and the real estate appraiser; the client almost always knows the answers, as will the real estate appraiser if asked the right questions.

Second, realize that the current cash balance is part of the overall business operation, and has to be increased with projected revenues, avoiding the "free growth" problem.

Third, account for future capital needs (CapEx). This may mean diverting cash flow to build the bank account, which will reduce distributions to partners (thereby increasing the discount from net asset value attributable to a partnership interest, and decreasing its value). The balance will be reduced when the forecast expenditure occurs.

Fourth, if capital is just plain inadequate, show it built up over time. This might not be what the partners will actually do, but diverting cash flow to build up cash reserves will model the inadequacy. Reality might involve periodic capital calls (a consequence accounted for by the buildup), which would certainly be considered by a fully informed buyer of the partnership interest.

Fifth, if capital is excessive, then show cash distributed over time so that the balance hits a reasonable point in (say) 10 years. The partnership might not do this either, but it is a fair way to represent a partner benefit that has to be realized *sometime*.

The IRS declares that excess cash cannot be discounted, and for a controlling party—who can determine whether to distribute or not—this is certainly the case. Otherwise, cash is part of the business operation just like for any other business. It must be ac-

counted for to fairly represent its worth to the noncontrolling partners. Treating cash the same as it would be treated in any other business valuation is most helpful.

All this and more

Blind spots abound. I have addressed another big one in the article, Whatever Happened to Specific Company Risk. These and all other issues pertain-ing to the valuation of asset holding companies are addressed in the book *Valuing Fractional Interests in Real Estate 2.0* which contains the entire body of knowledge on this topic. The book provides two case studies (part-nership and common tenancy) and demonstrates exactly how to prepare complete and persuasive valuations. You may also take advantage of PrimusPVX© an online valuation/teaching platform that guides you through the process of the same valuations by making it faster and easier.

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