Dennis Webb's
Multidisciplinary Guidance and Insights Letter #2

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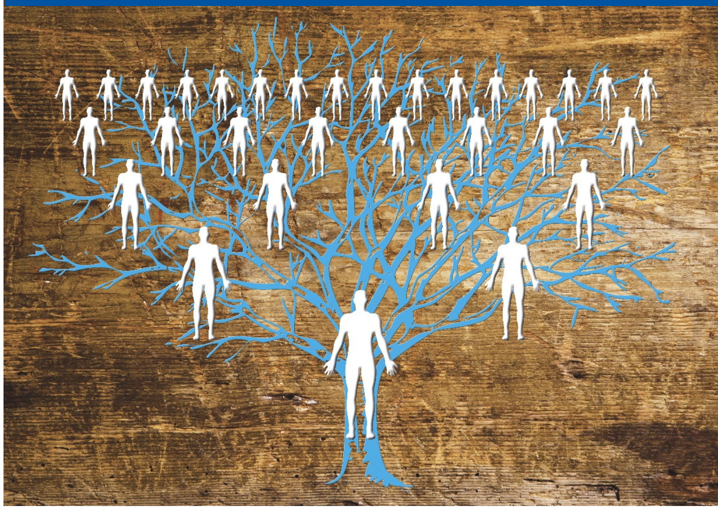
The Rapid Rise of Real Estate in Transition Planning



Business appraisers have supported clients' exit/transition planning for operating companies over many decades. But the great wealth that families hold in real estate assets has largely been missed. That's because you can just sell the real estate and distribute the proceeds. Problem solved, right? Not by a long shot.

An enormous quantity of real estate is held through partnerships and other ownership structures that were created for various reasons, but are certainly not going away. Future generations will struggle to preserve family legacies unless transitions provide for management and interest-holder buyouts in much the same way they do for operating businesses. But the analysis and stories of value are different from operating businesses, and our professions are not yet ready.

The Past and Future of Fractional Interests

Fractional interests in real estate are mostly created when there are substantial benefits to be gained, for example, by pooling resources for purchasing and improving property, or splitting usage of a property that would otherwise be prohibitively expensive. Such interests generally are formed by investing at a premium because the circumstances provide intangible benefits; but those benefits evaporate over time. The acquired interest is like a new car, whose value declines substantially once you drive it off the lot. We refer to this value loss as a "discount" from the interest's share of the whole property.

Their creation has an historic context. The successful post-WWII developers and their partners have created fortunes by acquiring and holding a great deal of real estate, much of which has supported their families ever since. The partners valued their original association, and the interests of Generation 1 and their children, Generation 2, are also more-or-less aligned. But the inescapable transition to newer generations creates new interest holders whose priorities naturally diverge over time. Even though successful, the newer partners are not necessarily "real estate people," and may not agree with how the family's assets are being managed, or even whether they want to remain part of the enterprise. This situation hasn't been all that visible, because Gen 1 was able to keep everyone's interests aligned through their "power of the pen" when necessary. That advantage will go away when they pass. And because of the historic timing, it is starting to go away on a fairly large scale right now.

How will ownership positions and management transfer from one generation to the next? How will agreement be reached on partner buyouts? My experience with recent cases suggests that many will not make it. It is just too hard to understand why limiting control also impairs the value of an interest. When Gen 1's guiding hand (and its pen) are no longer there, in-fighting can easily dissipate or destroy the family legacy.

Real Estate Transitions Have Been Ignored

Exit/transition planning has been a key topic forever, at least with respect to operating companies. But asset-related transition planning has received no attention. After all, if the real estate assets are a problem, just sell them, right? The statement is correct as far as it goes, but most of the partners usually have to agree, so good luck with that. We have provided almost no guidance on how are exits and transfers are to be managed.

Creating an internal market for later generations' interests is imperative, and discounts are a reality. After all, the buyout removes future uncertainty for the exiting party entirely, but it is unchanged for those remaining in the business or partnership. The need is the same as for operating company shares, but real estate ownership faces an additional hurdle, as discounts are readily apparent, but their justification is not easy to communicate.

There are a great many reasons that limited control and marketability reduce value. Still, valuers often disagree on how to address the family's specific ownership conditions, intangible benefits and detriments, real estate risks and other key facts and circumstances. Clarity is essential if our work is to be understood and relied upon by the client.

Clarity is Needed to Produce Agreement

Valuation methods that rely strongly on judgment are most likely to lead to failure. This is easily observed when partners end up in a courtroom where each side has its own experts. Quantitative methods that apply objective standards to the facts and circumstances of the case are more readily understood than alternatives that rely heavily on the expert's judgment. For example, how does the valuer account for the partnership's property management risk in comparison to public market data? Or specific buyer and seller attributes of control, which can vary widely. How does the valuer account for differences between the partnership's "inside" property operations and the "outside" market reflected in the real estate appraisal? A detailed breakdown of important facts and cir-cum-stances, and applying data in a systematic way that limits judgment, is more likely to foster agreement between the parties than vague assertions from the expert.

Next Steps

A LOT of real estate is now held by multiple parties, and those partnerships, LLCs and common tenancies are not going away anytime soon. I believe it is essential for our professions to recognize the special case of the "business of holding real estate," and for more of us to become proficient at valuing fractional interests in a way that is meaningful for our clients—so partners can realize that their exit price is fair.

I recommend that you consider "Valuing Fractional Interests in Real Estate 2.0," as it demonstrates that conventional valuation methods can be applied to fractional interest circumstances in a comprehensive way. It replaces judgment with a rigorous application of data to the facts, and provides a framework that the valuer can use to tell a coherent and complete story of value.

I have come to realize that, in addition to concluding value, we can provide more: a persuasive understanding of value that can greatly help families secure management of their real estate holdings for the benefit of future generations. I believe that valuers who accomplish this will see enormous opportunities open up now and in the coming years.

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