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Projecting the Balance Sheet

Multidisciplinary valuation poses quite a number of challenges, not the least of which is adapting knowledge developed in one discipline for use with the other. In-discipline bodies of knowledge are prodigious, and knowing what can be used, what can be adapted and what just doesn't work is a big key to successful multidisciplinary practice.

I am happy to report that there are some important similarities—chief among them the magical income approach to value—that work across disciplines and can be really helpful. This article concerns one element of that approach that will be familiar to business valuers and that can be readily adapted for fractional interest valuation: *projecting the balance sheet.*

The Business of Real Estate

Holding and operating real estate is a business, regardless of structure. All of the elements needed to operate a business must be in place whether it has a single owner, multiple owners as partners or multiple owners as tenants-in-common. It is therefore useful to analyze real estate holding as a business.

Just like an operating company, an asset holding company must have operating cash, and often has deposit accounts and debt in addition to its real estate asset. Discounted cash flow models require that cash flows be projected for a time. This includes the debt service, capital expenditures and working capital contributions that will impact those cash flows and the reversionary interest in the business.

A key difference between operating companies and asset holding companies is that an operating business is usually expected to operate in perpetuity. The holder or holders of a real estate asset are generally expected to realize the value of the asset at some point in time as part of their total return.

Future value involves more than just the eventual selling price of the real estate, so the valuer needs to address not just the property asset, but all of the other assets and liabilities of the real estate business. Accordingly, the valuer needs to project the balance sheet. Balance sheet items for real estate holding companies usually include working capital, fixed assets, and long-term liabilities like security deposits, mortgage debt and maybe other notes payable and receivable.

Working Capital

Working capital is comprised of current assets less current liabilities. Cash is usually the biggest contributor, with smaller amounts from tradeable securities, deposits, and miscellaneous short-term receivables and payables. There can be a lot of cash or a little, and the amount matters.

Cash on hand is required for all but the most extreme real estate holding businesses, and such needs must be considered by the valuer. Just as it is with operating businesses, working capital should be increased with revenues, since the business would otherwise end up with free growth, which is not possible over the long term. But real estate companies also have specific needs to consider; for example, future repairs or capital expenditures will need money from somewhere, and if the partners don't have enough working capital to cover these expenses, then the partners will need to start writing checks at some point (and often do). Cash requirements are property type dependent:

- Multitenant retail and office often require expenditures for tenant improvements on turnover (depending on market conditions) and/or to cure functional obsolescence (which can be a quite expensive proposition). Such costs might not be considered in a market value appraisal, depending on timing and market transactional data, so further investigation might be required.
- Apartment turnover costs are usually included in the appraiser's annual reserve allowance, but reserves are often understated.
- Major updating needs may also not be included in the appraisal, based on market demands and timing.
- Some triple-net leased properties might not need any cash whatever, at least during the lease term. But this state will eventually change, and retenanting or adaptive reuse of the property (especially if nonrenewal is not anticipated) can be financially daunting.

Some of these future needs can be accounted for with reserve allowances, either by reducing the net operating income generated by the property or by taking additional allowances at the partnership level if the real estate appraisal's market allowance isn't sufficient. Another type of allowance is taken for vacancy and collection loss. But taking

a little each year is only intended to reduce value based on long-term average cost. The valuer must not only make sure ongoing costs are still covered *on average*, but provide for a cushion that a prudent owner of that specific property type would be expected to have at that time in that specific market.

The valuer can interview both the owner and real estate appraiser to determine a reasonable working capital amount, often expressed as a number of months' revenues. That level is an integral part of the business. If currently too low, the valuer can build it up by diverting cash flow so that it is adequate by at least the end of the projection period. The problem is a little trickier if the partnership is holding too much cash. The valuer will need to first find out why; maybe for known future costs, maybe because they want to buy another property (in which case it's an unknown future asset), or maybe because it hasn't yet been distributed (in which case it should be normalized to equity). If just high, then the valuer can show a portion adding to yearly distributions until the amount becomes normal. Of course, if the holder of the interest being valued can get access to the cash, then perhaps it is just a nonoperating asset that should be distributed.

Real Property

Fixed assets are mostly real property and related assets that will likely be included in the asset appraisal. While future value can often be a simple projection of present value, the projection should also take into account any changes in highest & best use, improvements, occupancy, or any other conditions likely to have changed by the end of the period. Current usage might be nonmarket; for example, continuing to operate older improvements when market conditions suggest that a typical buyer would replace them with new construction. Benefits to the partners might be reduced currently, but showing a terminal value based on the new use (in that case, sale to a developer) makes sure the valuation includes that future potential.

Projecting future value is also useful when the current market is either over-exuberant or has failed (yes, I am definitely old enough to know that both do occur). This is a helpful valuation technique when market conditions are weird, since current property value (assuming it can be determined at all) might not be meaningful and isn't accessible by the partners anyway.

Mortgage Debt

Smaller partnerships don't change their capital structure very often. Balances are paid down and equity builds up. Loans may be refinanced if capital market rates decline or if the partners wish to extract some tax-free equity, but that is about it. Both interest and principal payments reduce cash flow, and the declining loan balance results in increased equity in the terminal year. Refinancings or variable interest rate terms might change the expected amortization. However, unless such future events are known with some certainty or widely expected by the capital markets, it is usually better to just hold the rate constant and forecast current conditions over the term.

(Note: This means that small partnership capital structures should not normally be compared with levered REITs or public limited partnerships for discounting purposes. REITs

change their borrowings to manage returns and risk, like operating businesses, which are often assumed to maintain a target capital structure. Real estate partnerships are better analyzed using their own expected loan amortization. Discount comparisons can then be made to unlevered REITs and public limited partnerships.)

Security Deposits

Leases very often require that the tenant provide a security deposit that would either be returned on their departure or transferred with the property to a new owner. Such deposits are rarely held in a separate account and sometimes not even identified. But the valuer should definitely have a credible schedule that has been provided by management, or otherwise the original lease and any amendments. Unless the lease provides for a deposit return date (unusual), any turnover during the period will most likely result in one deposit returned and another received. In most cases the valuer will just project a flat deposit amount over the term.

Other Assets and Liabilities

Other line items should be small, in which case they can usually just be projected unchanged. Notes to or from partners, nonoperating assets, and the like can be normalized as they would be in any business valuation. A large securities portfolio might require the valuer to financially bifurcate the partnership through the minority-marketable level, analyzing control loss for the securities separately from the real estate.

Terminal Value

The entire point of projecting the balance sheet is to determine a terminal equity value that matches external market conditions. Even if the partners intend to hold the property forever, recognizing a terminal value still helps the valuer to fully and explicitly incorporate underlying value that will eventually percolate up and be realized by the partners.

Stay tuned for more on how the income approach helps the valuer tell the real story of the partnership and its fractional interest holders. You can find the above detail worked out in partnership and common tenancy case studies in *Valuing Fractional Interests in Real Estate 2.0*, at www.primusivs.com.

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