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Valuing Single-Family *Ownership*

Appraising single-family real estate can be challenging, but for reasons that are at least pretty well known. Appraising single-family *ownership* (undivided interests in single-family real estate) is often seen as challenging, but for reasons that are *not* well known.

As it turns out, valuing undivided (fractional) interests in single-family residences (SFRs) does not have to be challenging at all. It is a practice that can be adopted by the appraiser as a logical expansion of their original work, providing a new market that appreciates and values their skill. This article offers a short pathway to sub-stantially increased revenue, either manually or by using the optional PrimusPVX© online valuation platform. This practice is eminently doable. There is a bit of a story to it, though.

Valuing fractional interests in SFRs has been important for many years, ever since transferring wealth to the next generation by dividing the family's real estate ownership became a popular estate planning technique. But current practice has created methodological speed bumps that have made reliable, meaningful and understandable valuations a challenge.

We will look at a) how the valuation professions have brought this practice to its current state; b) why a shift in point of view is the key to changing it; and c) the principles and

other understandings that make it work. It concludes with specific steps appraisers can take to adopt an essential and lucrative practice niche that benefits everybody: appraisers, the public and other users of valuation reports. Client demand is skyrocketing, making this the perfect time to take action.

Origins

Business valuers began valuing interests in real estate partnerships 40 years ago. But deeded, tenant-in-common positions do not resemble partnerships or other businesses, and their tight relationship with the real estate has caused many to avoid this type of valuation. Others press ahead anyway, but technologies designed to value operating businesses do not usually result in a persuasive story of value, because the facts concerning real estate ownership do not appear to have much to do with business operations. Or do they?

Two methods in current practice are logical and often useful: partition analysis and comparable transactions. Unfortunately, partition analysis loses itself around improper risk analysis and the absence of meaningful facts,[1] and comparable trans-actions are so difficult to analyze that useful data is almost never found.[2]

The difficulties are not really anyone's fault. They are structural, since this practice is neither real property appraisal nor business valuation, but a partial integration of both. The needed correction is not all that complicated.

Points of view

The business valuation (BV) view is designed to be entity-centric, with assets as balance sheet items. Facts associated with those assets have a way of taking a back seat, or being viewed very generally. Meaningful real estate facts can be especially elusive, so many business valuation methods have difficulty connecting with them. This was an understatement in the well-known case of *Ludwick v. Comm'r*,[3] in which two very experienced and respected business appraisers tried to apply a shopping list of BV methods to an interest in a Hawaii vacation home. They were unpersuasive[4] to the point that the judge disregarded every one and made his own valuation.

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[1] Dennis A. Webb, ASA, MAI, FRICS *Valuing Fractional Interests in Real Estate 2.0*. (Milonguero Press, Los Angeles 2021): 267-274. Partition analysis is usually required, but is a bit tricky, since it implies a market for buyers who are willing to bring a lawsuit against their "partners." You can also find a short article on partition here.

[2] Ibid: 274-282. Discount indications from fractional interest transactions exhibit an extremely wide range, and require that the appraiser gather far more information than is needed for whole property transactions. This doesn't happen a whole lot, making the entire process no more reliable than a dartboard. You can also find a short article on sales comparison here.

[3] *Ludwick v. Comm'r*, T.C. Memo. 2010–104. See also Webb, "Ludwick: A Wake-up Call for Lawyers," *LISI Estate Planning Newsletter #1687* (Leimberg Information Services, Inc., August 18, 2010), here.

[4] For example, it is really difficult for laypeople to understand what tender offers for majority interests in public companies, or transactions involving public partnership interests, have to do with a vacation home.

The real property (RP) view is necessarily different. It begins with the real estate asset and its market, which usually considers typical ownership, not actual ownership. Typical property operation by typical market participants leads to market value. So far, so good. Interestingly, the meaningful facts—the ones that usually go missing in the BV view—are within easy reach for the real estate appraiser. Substitute current ownership for the "typical market participant," then consider the risk and benefits for a postulated typical seller/buyer acquiring such an interest. What would they receive in return? How would they see benefits and risks in their association with the other, actual owners? What would their exit options look like if things didn't go well in the future?

These elements are so closely tied to the property ownership and operation that is already analyzed in the existing appraisal process, so extending the appraiser's scope of work to include them is a fairly small step. Unlike the business valuer trying to recognize the facts, which is asking quite a lot. Doesn't usually happen.

Conditions of sale

Thorough single-family residential (SFR) appraisals include confirmation of comparable transactions with at least one party to the transaction, the objective being to determine whether there were any nonmarket "conditions of sale" that affected the transaction price. While there are many conditions that require price adjustments—personal property included in the sale, seller paying buyer's portion of closing costs, seller buying down the loan interest rate or paying points, expenditures made immediately after purchase, and more—the most important can be intangible benefits.[5]

One of the most common intangibles is owner-occupancy. It is usually easy enough to select owner or investor transactions so that such a market-wide benefit does not have to be analyzed, but it exists nonetheless. The benefit can be observed in many property types (corporate office and industrial, for example), but is certainly most common with SFRs. We now have many investor-owned SFRs, so the distinction is becoming more important.

When the property right conveyed is an undivided interest in the property, rather than a 100% interest, owner-occupancy and personal-use attributes become a critical part of the fact pattern affecting the value of that interest. In my view, owner use objectives are one of the most interesting appraisal elements to resolve.

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[5] Appraisal Institute, *The Appraisal of Real Estate*, 15th ed. Chicago: Appraisal Institute, 2020: 382–385. Conditions of sale include the motivation of buyer or seller who is under undue duress to complete the transaction, a non arm's-length relationship between buyer and seller, as well as many tangible conditions such as financial concessions involving personal property, financing and the like.
Any nonmarket personal benefit received or given up in the transaction can also qualify as a condition of sale that needs to be adjusted. Fractional interest transactions can easily have many personal, intangible benefits that have an enormous effect on the price paid.

Personal use and fractional ownership

I currently specialize in valuing fractional interests in real estate, which has led me to focus on property *ownership* as much as the real estate itself. I am also designated in business valuation. I have valued a great many fractional interests in SFRs, vacation homes and rentals. While there are key analytical similarities among all types of fractional interests in real estate, SFRs pose unique intangible benefit issues that must be resolved before a story that adequately supports the valuation can be written.

For example, say two grandparents build a vacation home so they can invite their children and grandchildren to visit. In *Ludwick*, the judge and appraisers concluded that if the hypothetical buyer of the grandfather's interest wanted to sell the property, the grandmother would readily agree (90% chance). Really? She would give up a newly constructed vacation home where she expected to spend time with her grandchildren? (I'm adding facts to the case here for illustration, but I have personally valued circumstances exactly like this.) I'd suggest that it is much more likely that anyone trying to force a sale would be met with a pretty ferocious response. Having thought such hypotheticals through, you can actually ask your clients what they would do. These sorts of material facts can have a huge effect on the value of the subject interest, and I think finding them is an interesting and fun part of the process.

There are lots of other personal circumstances. A buyer might pay more than his pro rata share of the property if the objective is occasional use (of a ski condo, for example). Of course, the issue of getting along with the other owners must be considered as well. A family vacation home could have generated so much intra-family conflict over the years (as one owned by my grandparents in Balboa, California did) that any usage benefit is overwhelmed by problems that are not likely to go away (and didn't). All of these circumstances can have an effect on value.

What is occupancy worth?

The most common valuation assignment involves gifts of shares in a home that is occupied by one party as their primary or secondary residence. In that case, the hypothetical buyer (and actual giftees) usually would have no occupancy right. I don't know about you, but if I just purchased a (say) 1/3 interest in somebody's house, I would want an occupancy benefit—or at least my share of the net operating income that would be realized if it were rented. This leads to one of the easiest ways to analyze ownership risk: develop an overall capitalization rate. First, appraise the real estate. Then, determine market rent and vacancy, subtract operating expenses, and conclude net operating income (NOI). The overall capitalization rate is then NOI divided by the appraised value. (This works with occupancy rights too, since renting would be an alternative to owner-occupancy.)

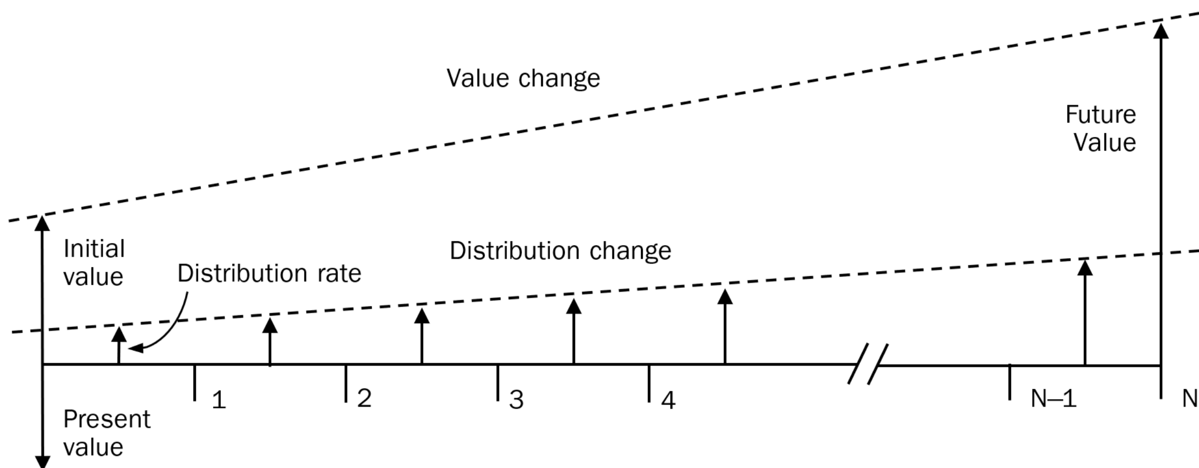
Value analysis is made transparent and quite easy when ownership objectives can be expressly stated, instead of just assumed. In this case, we now have an overall rate. All we need is growth expectations (projections made from market observations) leading to a future value, and voilà! We have the ingredients for a nice, simple discounted cash flow

(DCF) model. First, the current value of the whole property is determined normally, usually by sales comparison. Then the fraction can be analyzed using the income approach, which pretty much solves everything. (If you now find yourself saying, "wait, do you really mean to use a DCF for an SFR?" Read on…)

Methods change, but owner objectives don't

People buy real property because of what they expect to receive in the future. In fact, this *must* be their objective. The cost approach, sales comparison approach and income approach are different ways of observing market activity, but they necessarily amount to the same thing: pricing the value of future benefits. For the parties to the transaction, it's all about their future with the property: either what the seller is foregoing or what the buyer is acquiring. In the sales comparison approach, that future is implicit; in the income approach, that future is explicitly stated, meaning transparent.

The present value (price) that generates future benefits (owner usage or payment for others' usage), looks like this:



The diagram shows the initial (appraised) value, projected to a future date. Distributions to the non-occupying interest holder—or value received from an occupant—are realized annually and grow at a market rate. The asset-level return can either be calculated as the overall rate + growth, or as the internal rate of return to the initial value. The key—increased risk due to the subject position being less than 100% ownership—is represented by increases to this asset-level rate. The present value of cash flows and future value is shown as a down arrow that is shorter than the initial-value arrow. The difference is the "discount" attributable to the fractional interest.[6]

We have just made explicit the future expectations of market participants, using a conventional, well-understood income method. While time horizons are not necessarily known market-wide, time does have to be included in this analysis. It represents the

[6] See Webb. supra: 203–205, 265. The discount amount = initial value – present value, and the % discount = discount amount / initial value.

interest holder's future expectation of how long they will be "stuck" in their position before they get their (undiscounted) share of the whole property.

This analysis works whether one is simply holding the interest, waiting for a future event, or forcing the issue through a partition lawsuit. Of course, as with all income methods, the analysis is most importantly represented by the yield rate, which is increased over its 100% ownership level by restrictions on property rights, control- and marketability-related risks, the same as for any fractional interest.

Adopting the practice is easy

Historic practice uses a mix of real property and business valuation methodologies that would normally take years to master. Fortunately, years of practice are not required. I wouldn't have written this if that were the only solution, because it would not be all that helpful for anyone, let alone residential appraisers wanting to add fractional interest valuation to their practice.

Fractional interest valuation finally has the tool it has needed for a long time: PrimusPVX®, your Partner Value Expert.[7] PVX is an all-in-one platform that guides appraisers to find the important facts, make key decisions about how those facts affect value, and then prepare a persuasive valuation report. It provides every resource needed, including the entire body of knowledge for this integrated BV and RP practice area, step-by-step guidance, and the necessary data. It takes advantage of your current knowledge and optimizes your valuation process while allocating the tedious parts to its algorithm. The result is fast, highly supportable and quite profitable fractional interest valuations.

SFR interest valuation is best done by an appraiser who understands the property and is close to the specific market—that's what makes it work. The long practice requirement is eliminated by using PVX. We're not talking 20 years anymore—assuming you're an otherwise experienced appraiser who has a working understanding of the income approach, we're talking two weeks. Seriously.

Ready to give it a go?

Training is not absolutely required, since PVX is self-instructing. However, it will certainly quicken the process and give you a solid understanding of how fractional interest valuation works, as well as specifics about client accounting, the algorithm's (conventional) valuation processes and principles, and report writing.

The three four-hour training sessions include 1) an overview of fractional interest valuation, its origins in valuation practice, valuation structure and unique SFR characteristics; 2) a case study involving our reanalysis and recalculation of *Ludwick v. Comm'r*, a brief review of available methodologies and a detailed look at methods that work; and 3) a valuation workshop beginning with decoding client circumstances,

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[7] PVX is an online valuation application that may be found at www.primuspvx.com.

working through student-submitted cases, and report writing. The sessions are delivered by Zoom, although they can be presented live if feasible.[8] The three training sessions are suitable for CE credit submissions that can be obtained by local appraisal association chapters. They are intended to prepare students to begin practicing right away.

The best part is that adding ownership analysis to appraisal work is a way to engage in greater depth with your appraisal clients, adding a lot of fun (and revenue) to your existing practice.

Conclusions

This article has made a case for appraisers adding fractional interest valuation to their basic real estate appraisals. Rather than repeating the unfortunate drumbeat of machines replacing appraisers, the story is now about appraisers using a machine to move into an otherwise untouchable practice niche in which their abilities are highly valued. The resulting fractional interest valuations are based on a straightforward risk/benefit analysis that considers how the actual owners expect to use the property—yes, real people and their real estate. Appraisers can easily find the important facts, and it is attention to the facts that makes all the difference.

Residential appraisers currently face a series of challenges that have made their work more difficult, so it's nice when something comes along that values their abilities and pays well on top of that. What's not to like? You can now diversify your practice, do more for your clients, make more money, and have fun too.

– Dennis Webb

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[8] Please contact Jenn@primusvaluations.com concerning your interest in training sessions and for a current schedule.