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Goldilocks and the Critical Importance of Time

The single most important thing about valuing a fractional interest in real estate is time: How long will the interest-holder be stuck in its position? Of course, this is also mostly true for a nonmarketable position in any business. But a key distinction applies for real estate holding companies, as the terminal event is defined as the interest-holder's likely realization of its pro rata share of the underlying equity (net asset value). Interest-holders have no particular reason to care about the current NAV, since they don't have access to it anyway. But they have reason to care a lot about its future value. Realizing this helps the valuer solve many dilemmas that would otherwise be nearly impossible. Concluding the likely period is a critical element in every such valuation.

Holding/Restriction Period

The end of the marketability restriction for any fractional interest most commonly occurs when the assets are sold and the proceeds distributed. If this is expected to actually occur, based on the facts, partnership term, intentions of the other partners, and so on, then concluding the time to sale is fairly straightforward. But there are other possibilities, such as the interest being bought out at its pro rata share of NAV, or the impairments being removed so that the interest holder is able to cause the assets to be sold at will (whether he or she actually would cause a sale). Whatever the situation, this restriction period has profound effects, and the valuer must carefully consider any circumstances that could affect the period. Valuing Fractional Interests in Real Estate 2.0 addresses the valuer's process for selecting a restriction period for partnerships and

for common tenancy interests in detail, as well as projecting the terminal NAV and managing the uncertainty connected with it all.

Goldilocks' Two Dilemmas

Investment modeling works best when the model period matches the period from which discount (yield) rates are taken. Most real estate rates involve investor expectations of five to 10-15 years, so this range should be no problem for DCF or present value. It is just right, like the porridge that Goldilocks tasted.

But what if the period is most likely "forever" instead? It is not uncommon to find partners who intend to hold their assets forever, and have a long history that seems to support the forever notion. Of course, forever means under the aegis of future generations, and we cannot know their intentions. Forever would require extremely firm support from the facts, but even a fairly long period of, say, 25 years, would still be rare. I have encountered only one such situation in more than 25 years of valuation practice.

I am pretty sure valuers are not expected to be prescient. In this case, we are only addressing the idea of the valuer's modeling period, not in training to be fortune tellers. Thus, what we need is what works. When it comes to model periods, I suggest that exceeding 10 to 15 years at the most creates an invalid model, because there is almost no way that discount (yield) rates can be found that support longer periods. I do know of one study that involved forest land in Finland. The study compared investment market transactions with legacy market transactions—apparently very long-term holding of forest land is an actual market participant objective. Yields for the investment market were in the 9%-range, as expected, but yields for the legacy market were closer to 4%. These data suggest that shorter-term rates will undervalue longer-term events. Investing for a specific return and leaving a legacy for my grandchildren are two different things. Fortunately, I have found that using 10-15 years is perfectly adequate for addressing returns and future value issues that show up in fractional interest valuations. So far, so good.

The other dilemma is the short term. What if the partnership's term ends and the partners either state that they don't want to extend, or the subject interest has a right to block an extension. Or even if they have been trying to sell a property in a difficult market, but the facts support some sort of market recovery in a year or two. With good support from the facts, a, say, 2-3 year restriction period could be concluded. So a short-term present value model can be constructed, but the yield rate is again a problem. Real estate investments do not commonly anticipate short holds, so short periods are not baked into the rates. The valuer now has a problem applying investment market rates to a non-investment market, because the investment market rates can drastically overvalue the interest. Isn't a short period better represented by models used in option markets? If so, what can we do about it?

We have Black-Scholes and other option pricing models that do indeed represent short-term market behavior. But how to apply such models to real estate holding companies? It seems like a pretty extreme stretch, but it turns out that the application can be done fairly easily. The trick is in the volatility term. But like all things Black-Scholes, the story that demonstrates its validity and process is a long one, and takes up an entire chapter in Valuing Fractional Interests in Real Estate 2.0.

Time in the Valuation Process

The preceding discussion involved present value and DCF models because, quite frankly, such models are the only way to be explicit about what is expected in the future, and the only way to be specific about the assumptions involved. Income methods are so flexible and understandable that there is really no other good way to deal with the facts of the case in your fractional interest analysis. The key expectations of the holder/buyer/seller of the interest—cash flows, cash flow growth, value growth and terminal value are all explicitly represented and quantified. Once the risk associated with all these elements is also quantified, the valuation is done.

I mentioned at the beginning of this article that NAV at the date of value has little meaning to an interest-holder, since they typically have no access to it. It might also be misleading, especially of the property's use is expected to change sometime in the future. There are many circumstances presented in Valuing Fractional Interests in Real Estate 2.0 that simply cannot be accommodated using NAV methods, but that income methods will value just fine. Of course, methods can also be mixed. The entire picture, and the key to persuasive valuations, is presented in Valuing Fractional Interests in Real Estate 2.0. Enjoy.