Partial interests can be painful fractions

Many users of appraisal services think that appraisers simply value real estate. In fact, it is the rights to real estate that we appraise. According to The Dictionary of Real Estate Appraisal, a fee simple interest in real estate refers to absolute ownership unencumbered by any other interest or estate, subject only to the limitations imposed by the governmental powers of taxation, eminent domain, police power, and escheat. While other interests such as leased fee and leasehold also exist in any of these cases an individual or legal entity may own only a partial interest in a property. In many of these situations the partial or fractional interest is likely worth less than it's pro rata share of ownership - a fact recognized by United States Tax Courts.

While the amount of discount associated with a partial interest is often subject to debate and different methodologies it is helpful to provide an example as to why such a discount to the pro rata value is appropriate. Recently I have been working with the largest single shareholder in an LLC, made up of three members, whose sole asset is a community shopping center. This shareholder has a 40% ownership percentage and his partners each have a 30% ownership share. Voting on issues such as financing, an asset sale and/or significant capital improvement projects requires either a majority (greater than 50%) or supermajority (greater than 75%) vote by the members, depending upon the issue. As a result the single largest shareholder (with a 40% share) has no ability to control any decision without an ally and certain decisions require unanimous consent. The problem with this type of situation can be exacerbated when the 30% shareholders form their own alliance thereby weakening the ability of the largest shareholder to control even small issues.

Some of the more obvious problems that can arise when a shareholder lacks control include the amount and timing of debt placed on a project or when or how much is invested in capital projects. Maybe the roof or a boiler could get by for one more year if an owner controlled the property him or herself but if the remaining partners believe that no time is better than now it may require an immediate capital contribution which a shareholder does not have.

In the case I am working on the largest shareholder is now interested in a different objective - selling the underlying real estate to fund his retirement and provide lump sums of cash to his heirs. Unfortunately, his partners have different objectives and they want to retain the asset. The 40% owner is now faced with less appealing alternatives that include selling his share to a third party - with the approval of his partners - or selling his interest to these same partners.

For illustration purposes let's assume that the property in question is a $10 million asset that is unencumbered by debt. While the 40% owner always thought that he had $4 million of equity at his disposal that is only the case if the other partners agree to sell the asset. However, if the sale is blocked by voting provisions in the operating agreement and the 40% shareholder attempts to market his weakened position he will likely have to take a substantial haircut in his equity holdings. Other buyers of his partial interest are aware of the illiquidity of the holdings as well as the lack of control in making important financial decisions. Preliminary interest in his position indicates that this may result in a discount of over 30% to the perceived $4 million of equity. While selling to the existing partners may provide a better financial alternative, these are savvy businessmen who understand the benefits of the leverage they hold through the operating agreement and they will likely still require a discount of 20% or more to the pro rata share of ownership of $4 million. With their purchase they could enhance their percentage of ownership at an attractive price and then sell the property down the road and take advantage of the equity they gained at their partner's expense.

When appraising partial interests many factors are considered. It is not just reaching the market value and adjusting for the percentage of ownership. Rather a partial interest will often result in a discount to a pro rata share - a factor that should be contemplated when operating agreements are set up. Carving out exceptions for things such as the deaths of partners may be a thoughtful provision if the partners have a positive relationship and want the estate of the deceased to receive the amount of equity that the original shareholder envisioned when the agreement was entered into. If not a shareholder may want to come to the realization that the whole can be worth more than the sum of its parts.

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