Tiered Discounts in Theory and Practice

Monograph Summary

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Shenehon Company

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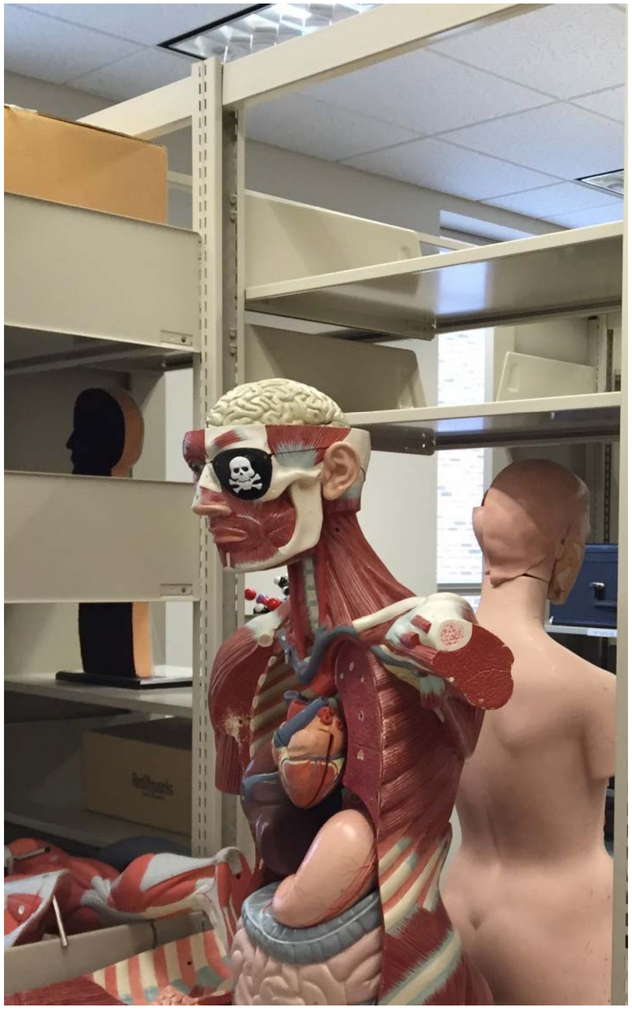
Appraisal Wisdom

Value is in the eye of the beholder.

– American Management Guru

For every complex problem, there is a simple solution that is wrong.

– George Bernard Shaw



What are tiered (or layered) discounts?

There are "multi-tiered entities and businesses inside of a business. Valuation theory permits separate discounts for lack of control and marketability at each ownership level to account for the incremental risk to which each new level exposes investors."

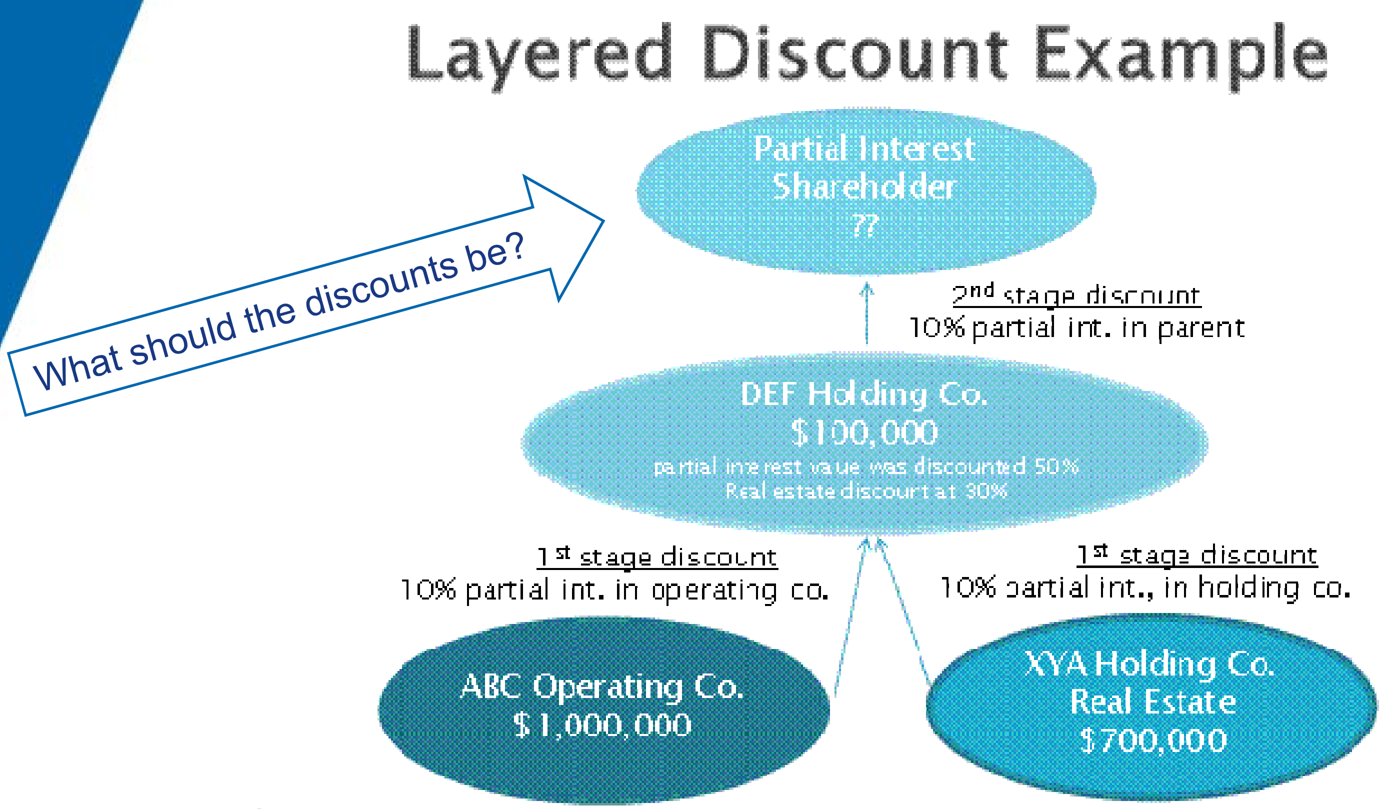
- Ciro V. Cuono, CPA/ABV/CFF, CVA, LGM-A

Introduction

WHAT IS THE IMPACT OF TIERED DISCOUNTS ON VALUE?

The use (or lack thereof) of Tiered (stacked, layered) Discounts significantly impacts the appraisal conclusion. Many appraisers do not fully comprehend the impact of such discounts, how to calculate them, or when to apply them.

Example of Layered Discounts



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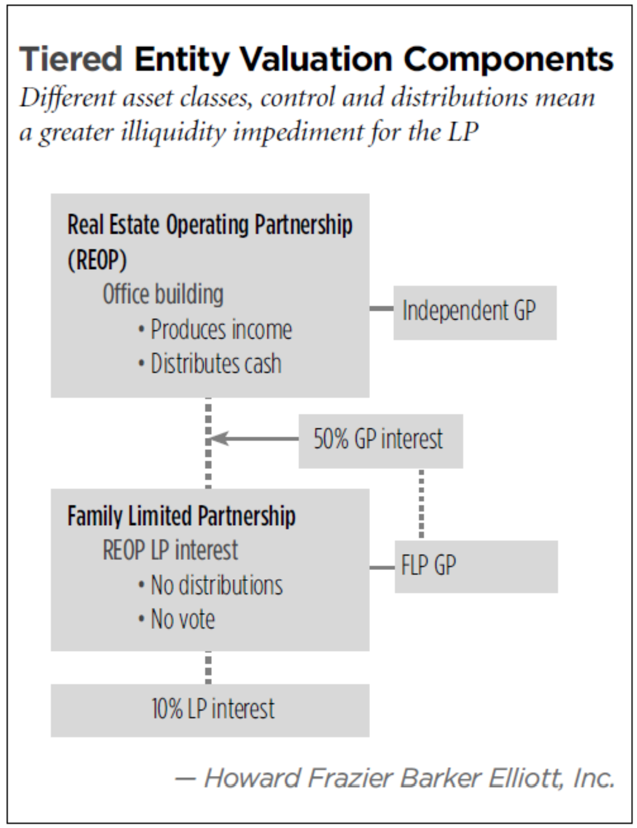
Example of Layered Discounts

Key to Discount's Size



Introduction

Appropriateness of the application of two or more levels of discounts:

Frequently, the taxpayer (client) holds a minority interest in one entity which, in turn, holds a minority interest in another entity. To accurately value a minority interest of this nature, the appraiser may decide it is appropriate to apply a discount for lack of marketability and/or a discount for lack of control at two (or more) levels.

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Introduction

Discount at the first level, then take additional discount at the second level:

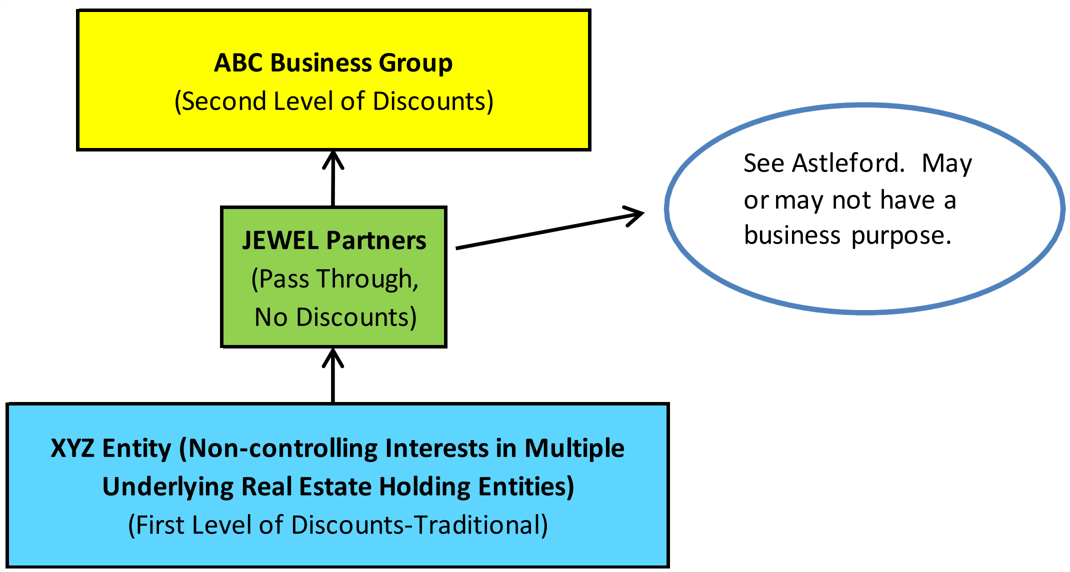
In order to arrive at the value of the subject minority interest, the appraiser discounts value based on the taxpayer's interest in the original entity (tier one). Subsequently, the appraiser discounts value a second time (tier two) to account for the additional lack of control and/or a lack of marketability which is a direct result of the subject entity being held by a second entity.

Introduction - Are we leaping too far? Maybe, maybe not. It depends on the facts.

The process is repeated at each level of ownership, reducing the net asset value little by little at each step.

Introduction

Can we all agree that when we value a real estate operating partnership, the end result is on a CASH basis?



Yellow	=	**Additional restrictions due to agreements, ownership structure, distributions and debt drive the additional discounts**
Green	=	**Limited restrictions (not material enough to require discounts)/Limited, if any, business purpose (pass-through entity)**
Light blue	=	**Basic non-controlling (minority) and lack of marketability discount analysis**

The above graphic summarizes the non-controlling interests illustrated in the flow chart on the following page. It is the non-controlling interests that are the subject interests being valued.

Impact on Value

How does using tiered discounts impact the appraisal conclusion? How do we determine the next tier of discounts?

- When dealing with tiered or layered discounts in an entity or partnership structure, the most important question is: How much additional discount for lack of control and/or lack of marketability should the appraiser take at the second level?

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Specialized Knowledge

Why does specialized knowledge improve the credibility of the appraisal outcome?

- Value Concepts
- Databases
- Experienced appraisers rely on information from a variety of knowledge bases to corroborate and verify the value concepts addressed in the given appraisal assignment. What databases are the most appropriate for different tiered or layered discounts?

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Specialized Knowledge

- **Closed End Equity Funds:** the appraiser must have an in-depth understanding of how closed end funds work and how the discounts are derived.

- **Asset Classes:** it is critical for the appraiser to recognize the nature and risk of the asset class being discounted. Familiarity with annual yield and appreciation for the various asset classes is also essential.

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Specialized Knowledge

- **Management:** the appraiser must understand the impact management has on a company's performance. For some companies, little to virtually **no** management is needed.

- **Agreements:** the appraiser should carefully review and consider the terms of the entity agreement(s) and the ownership structure in place (governance).

Specialized Knowledge

- **Relevant Court Cases:** a comprehensive study of decisions dealing with tiered or layered discounts will reveal key issues for the appraiser to address in the report.
- Estate of Astleford (see next slide)
- Estate of Dean: liquidation rejected – NAV accepted – two tiers of discounts accepted
- Estate of Gallun: no discount for capital gain on the assumption of liquidation – court did allow two tiers of discounts
- Estate of Gow
- Estate of Martin: disallowed multi-tier discounts

- **In *Astleford v. Commissioner*, the court concluded that multi-tier discounts are appropriate when the lower tier interest constitutes a relatively small percent of the upper tier.**

	Ownership interest	Discount
Tier 1	Rosemont farmland proeprty	20% absorption discount
Tier 2	50% general partner interest in Pine Bend	30% discount for lack of control and marketability
Tier 3	Limited partner interest in AFLP	35% discount for lack of control and marketability
		63.6% effective combined discount*

*Note: The combined result of the tiered discounts is multiplicative, not additive, If the property had a net asset value of $100, its value inside AFLP was only $36.40 [$100 x (1 - 20%) x (1 - 30%) x (1 - 35%)]

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Critical Points to Address

What are some of the significant issues for the appraiser?

- There are several crucial points to address when appraising tiered or layered entities:
  - How will the appraiser deal with multiple levels of governance structures?

Critical Points to Address

– How does the appraiser arrive at appropriate discounts when there is no market data to support the discounts selected?

– How does the appraiser accurately describe (in the report) what is actually being valued?

– FMV – uses the same studies

Relevant Practice Concepts

What are some of the significant practice concepts?

- If using the net asset value (NAV), determine current net asset value and subtract all liabilities to arrive at net equity. Revenue Ruling 59-60 "suggests" the appraiser place the greatest weight on adjusted net asset value. If using this approach, all assets should be adjusted to the current economic value.

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Relevant Practice Concepts

- Outline the ownership structure as clearly as possible (CRITICAL)
- Do a clear flow chart
- Determine discount for lack of control (DLOC) and discount for lack of marketability (DLOM) at each entity level

Implementation Pitfalls

What are some of the practical implementation issues?

- “When you stretch, or tier, partnerships miraculous things can happen.” (William Frazier, ASA, 2004)
- Does your result follow common sense?

Implementation Pitfalls

- By stacking or layering partnerships, valuable assets can be rendered virtually worthless.

- Markets of today are far more liquid and efficient than they were in years past. Partnership Profiles states that, on average, it is 45 days to cash.

Implementation Pitfalls

- How do you avoid the double-counting of discounts? Understand that at tier one, the value is on a liquid cash basis.

Alternative Approaches

What are some of the alternative approaches to completing this area of the appraisal assignment, with contrasting risk and benefits?

- The appraiser may elect to use a top-down approach rather than the traditional bottom-up NAV approach. The top-down approach looks at discounted yield and time of sale (marketing time) of the lower entity, basically, a discounted cash flow approach.

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Alternative Approaches

- See Dennis Webb's "Creating Order Out of Chaos."
- The top-down approach looks at discounted yield and time of sale (marketing time) of the lower entity, and at the next level, basically, a discounted cash flow approach.

Alternative Approaches

- The appraiser might also look at dividend yields with a sell-off in *n* years.

- Using the top-down approach may help the appraiser avoid double-counting discounts by assessing the risks of the cash flows. It may also produce a value that does not make logical sense.

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Sample Case Study

ABC Business Group
(Second Level of Discounts)

↑

JEWEL Partners
(Pass Through,
No Discounts)

↑

XYZ Entity (Non-controlling Interests in Multiple Underlying Real Estate Holding Entities)
(First Level of Discounts-Traditional)

- [yellow] = **Additional restrictions due to agreements, ownership structure, distributions and debt drive the additional discounts**
- [green] = **Limited restrictions (not material enough to require discounts)/Limited, if any, business purpose (pass-through entity)**
- [blue] = **Basic non-controlling (minority) and lack of marketability discount analysis**

Exercise - Defining the Assignment

What are we valuing?

The assignment is to value a 30.6% Limited Partnership Interest in ABC Business Group

ABC Business Group

(Second Tier)

Name of Business:	ABC Business Group
Location:	5000 April Way Anytown, Minnesota
Class of Business:	Limited Partnership
Date of Valuation:	March 15, 2015
Owner(s), % Holdings:	Various
Adjusted Book/Market Value:	$5,075,611

Defining the Assignment

Valuation as of March 15, 2015 - Stage II Layered Discount

Asset Approach (NAV):		**ABC Business Group**
100% Fair Market Value of Entity		*$5,075,611*
Subject Limited Partnership Interest		**30.613334%**
Pro Rata Value Before Discounts		$1,553,814
Less: Minority Discount	10.0%	($155,381)
Market Value with Minority Discount		$1,398,432
Less: Lack of Marketability Discount	5.0%	($69,922)
Fair Market Value of Interest		**$1,328,511**
		Rounded To
		$1,329,000

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Review of Governing Documents

Stage II Discounts

- Ownership Structure
- Governance
  - Control
  - Operating distributions
- Partnership Changes
- Debt and Distributions

Balance Sheet Review and Analysis

Balance Sheet Economic Adjustments - Assets
ABC Business Group / Jewel Company

Year	Historic 29-Feb-15	Adjustment	Economic 15-Mar-15
Current Assets:			
Cash	$95,882		$95,882
Investments	$535,177	($143,347)	$391,830
USA Financial	$455,518	($179,716)	$275,802
Loan Receivable - Gth Supply	$124,755	($49,902)	$74,853
Total Current Assets	**$1,211,332**	**($372,965)**	**$838,367**
Fixed Assets:			
Land, Building, Improvements, Equipment	$0	$0	$0
Other Fixed Assets	$0	$0	$0
Total	**$0**		**$0**
Less: Depreciation	$0	$0	$0
Total Less Depreciation	**$0**	**$0**	**$0**
Other Assets:			
49% LP INT - JEWEL Partners *	$717,237	$5,147,460	$5,864,697
Total Other Assets	**$717,237**	**$5,147,460**	**$5,864,697**
TOTAL ASSETS	**$1,928,569**		**$6,703,064**

Pass-through entity – no additional discount

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Balance Sheet Review and Analysis

Balance Sheet Economic Adjustments - Liabilities

ABC Business Group

Year	Historic 2/29/2015	Adjustment	Economic 15-Mar-15
Current Liabilities:			
Current Liabilities	$0		$0
Total Current Liabilities	**$0**	**$0**	**$0**
Other Liabilities:			
Long-Term Debt	$0		$0
Total Other Liabilities	**$0**	**$0**	**$0**
Total Liabilities	**$0**	**$0**	**$0**
Equity:			
Equity	$1,928,569	$4,744,495	$5,075,611
Total Equity	**$1,928,569**		**$5,075,611**
Total Liabilities/Equity	**$1,928,569**		**$5,075,611**

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First Tier Valuation

What does XYZ Entity contain?

Ownership in
XYZ Entity
March 15, 2015

General Partner	Ownership %
Brooke Trout	1.0%
Roger Smith	1.0%
Limited Partners	**Ownership %**
Sushi Group	49.0%
ABC Business Group/Jewel	49%
Total	**100.0%**

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First Tier Valuation

Historical Distributions - XYZ Entity	FYE Dec-12	FYE Dec-13	FYE Dec-14
Distributions	$296,000	$319,700	$356,650
Net Income	$418,320	$364,615	$394,782
Distributions/Net Income	71%	88%	90%
Estimated Partner Tax Liability: 40% of NI	$167,328	$145,846	$157,913
Distributions Excess of Partner Tax Liability	$128,672	$173,854	$198,737

Balance Sheet Review and Analysis

XYZ Entity - Flows into Jewel Company

	Year	Historic 29-Feb-15	Adjustment	Economic 15-Mar-15
	Current Assets:			
	Cash	$198,770		$198,770
	Total Current Assets	**$198,770**	**$0**	**$198,770**
	Fixed Assets:			
	Land, Building, Improvements, Equipment	$0	$0	$0
	Other Fixed Assets	$0	$0	$0
	Total	**$0**		**$0**
	Less: Depreciation	$0	$0	$0
	Total Less Depreciation	**$0**	**$0**	**$0**
	Other Assets:			
(A)	50% INT - Oak House Apartments, LLC	$39,428	$644,572	$684,000
(B)	50% INT - Seaside Park Apartments, LLC	$161,205	$1,064,795	$1,226,000
(C)	50% INT - Land Court Apartments, LLC	$175,108	$1,686,892	$1,862,000
(D)	16.67% INT - Spring Properties	$88,259	$1,211,741	$1,300,000
(E)	50% INT - Fireside Apartments, LLC	$155,562	$2,163,438	$2,319,000
(F)	25% INT - Wood Estates, LLC	$151,174	$1,466,826	$1,618,000
(G)	50% INT - Lakeside Apartments, LLC	$173,298	$1,699,702	$1,873,000
(H)	16.6667% INT - Apple Partners, LLP	$311,302	$244,698	$556,000
(I)	16.667% INT - Tide Partners, LLP	$135,162	$196,838	$332,000
	Total Other Assets	**$1,390,498**	**$10,379,502**	**$11,770,000**
	TOTAL ASSETS	**$1,589,267**		**$11,968,770**
	Times: 49% Pro Rata Interest		**49%**	
	PRO RATA VALUE (BEFORE DISCOUNTS)			**$5,864,697**

Pro Rata

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Balance Sheet Review and Analysis

SUMMARY AND INDICATED PRO RATA VALUE

Current Assets	$198,770
Net Fixed Assets	$0
Other Assets	$11,770,000
Total Assets	$11,968,770
Less: Total Liabilities	$(0)
100% adjusted Net Equity	$11,968,770
Times: 49% Pro Rata Interest	49%
Pro rata Value (No Discounts Applied)	$5,864,697

Balance Sheet Review and Analysis

Balance Sheet Economic Adjustments - Liabilities

XYZ Entity

Year	**Historic 2/29/2015**	**Adjustment**	**Economic 15-Mar-15**
Current Liabilities:			
Current Liabilities	$0		$0
Total Current Liabilities	**$0**	**$0**	**$0**
Other Liabilities:			
Long-Term Debt	$0		$0
Total Other Liabilities	**$0**	**$0**	**$0**
Total Liabilities	**$0**	**$0**	**$0**
Equity:			
Equity	$1,589,267	$10,379,502	$5,684,697
Total Equity	**$1,589,267**		**$11,968,770**
Total Liabilities/Equity	**$1,589,267**		**$11,968,770**

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Balance Sheet Review and Analysis

XYZ Entity - 49% Interest

Equity Before Discounts		$5,864,697
DLOC	15%	($879,705)
		$ 4,934,992
DLOM	15%	($747,748)
Net Value After Discounts		$ 4,237,244

Flows to ABC

Discount Analysis

In one case pertaining to layered (Second Stage) discounts, *Roy O. Martin, Jr. v. Commissioner*, 50 T.C.M. 768 (1985), the same discounts for lack of control and lack of marketability were applied at both levels, at the direct partial ownership level (first stage) AND at the second-stage level.

Discount Analysis

The Court stated clearly that this was incorrect…
“we conclude that the second stage 50-percent discounts are mostly duplicative of the 50 percent discounts applied at the level of the underlying corporations and, therefore, they unreasonably reduce the value of Arbor shares.”

Why lower discounts at level two?

- Risks and desirability have been substantially reduced at the first level of discounts.
- By definition, the market value of this holding is reduced to cash or cash equivalent.
- Second Tier is further restricted by another set of governance rules (lack of control) and even fewer buyers (lack of marketability).

Determining DLOC at Level Two

- Normal studies should be used – majority of Class of Assets were cash equivalent (already discounted)
- Core closed-end funds are used – most comparable

Core Closed-End Funds

Fund Name (Ticker)	Asset Class	Market Return	Prem/ (Disc)
Cornerstone Total Return (CRF)	Core Funds	-1.77%	11.21%
Engex Inc (EGX)	Core Funds	-2.12%	-18.14%
Advent/Clay Enhcd G & I (LCM)	Core Funds	-3.36%	-21.49%
Old Mutual/Claymore L-S (OLA)	Core Funds	-7.14%	-19.72%
Liberty All-Star Growth (ASG)	Core Funds	-8.88%	-17.86%
Source Capital (SOR)	Core Funds	-9.09%	-14.79%
Cohen & Steers CE Oppty (FOF)	Core Funds	-10.04%	-5.18%
Nuveen Core Equity Alpha (JCE)	Core Funds	-10.72%	-15.47%
DWS Dreman Val Inc Edge (DHG)	Core Funds	-11.44%	-21.83%
SunAmerica Foc Alpha LCp (FGI)	Core Funds	-11.62%	-16.32%
Central Securities Corp (CET)	Core Funds	-11.81%	-21.56%
Tri-Continental Corp (TY)	Core Funds	-12.17%	-5.77%
Blue Chip Value Fund (BLU)	Core Funds	-13.62%	-18.15%
S&P 500 GEARED Fund (GRE)	Core Funds	-13.63%	-3.94%
Clay/Ray James SB-1 Eqty (RYJ)	Core Funds	-13.73%	-0.65%
Adams Express Company (ADX)	Core Funds	-14.39%	-16.91%
Zweig Fund (ZF)	Core Funds	-15.05%	-18.77%
Boulder Growth & Income (BIF)	Core Funds	-16.31%	-23.23%
Royce Micro-Cap Trust (RMT)	Core Funds	-18.51%	-9.13%
General Amer Investors (GAM)	Core Funds	-18.85%	-17.86%
Royce Value Trust (RVT)	Core Funds	-20.14%	-8.97%
Liberty All-Star Equity (USA)	Core Funds	-20.81%	-22.48%
Gabelli Div & Inc Tr (GDV)	Core Funds	-22.40%	-16.90%
Defined Strategy Fund (DSF)	Core Funds	-26.97%	-4.41%
Eagle Capital Growth (GRF)	Core Funds	--	-14.92%
	Average Discount		**-13.73%**
	Median Discount		**-14.77%**
Inter-Quartile Range	**-8.97%**	**to**	**-18.77%**

Second Tier

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Lack of Marketability Discounts

Relevant Facts for Lack of Marketability Discounts	
Limited Partner does not control, the General Partner has all control	DISCOUNT ⇧
General Partner determines distribution	DISCOUNT ⇧
Assets are on a cash equivalent basis	DISCOUNT ⇩

This is down today.

Range of Lack of Marketability Discounts	9% to 19%
Selected Lack of Marketability Discount	15%

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Lack of Marketability Discounts

Summary of Results of Restricted Stock Studies

Study	Date of Study	Number of Observations	Median Discount	Mean Discount	Range of Discounts Low	Range of Discounts High
SEC Institutional Investor Study	1969	398	24%	26%	-15%	80%
Gelman Study	1968-1970	89	33%	33%	less than 15%	greater than 40%
Moroney Study	1968-1972(approx.)	146	34%	35%	-30%	90%
Maher Study	1969-1973	34	33%	35%	3%	76%
Trout Study	1968-1972	60	N/A	34%	N/A	N/A
Stryker/Pittock Study	1978-1982	28	45%	N/A	7%	91%
Willamette Management Study	1981-1984	33	31%	N/A	N/A	N/A
Silber Study	1981-1988	69	N/A	34%	-13%	84%
Hall/Polacek Study	1969-1992	100+	N/A	23%	N/A	N/A
Management Planning Study	1980-1996	53	24.8%	26.8%	0%	58%

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Lack of Marketability Discounts

- We use MPI-Study discounts for lack of marketability even though it is based on operating companies
- Keep in mind: the asset class is a cash equivalent which reduces the risk
- Based on Gross Income, Earnings, and Earning Stability, the range of DLOM was 14.1% to 21.81% (this has receded as of today)
- Use Judge Laro’s Ten Points to help quantify DLOM

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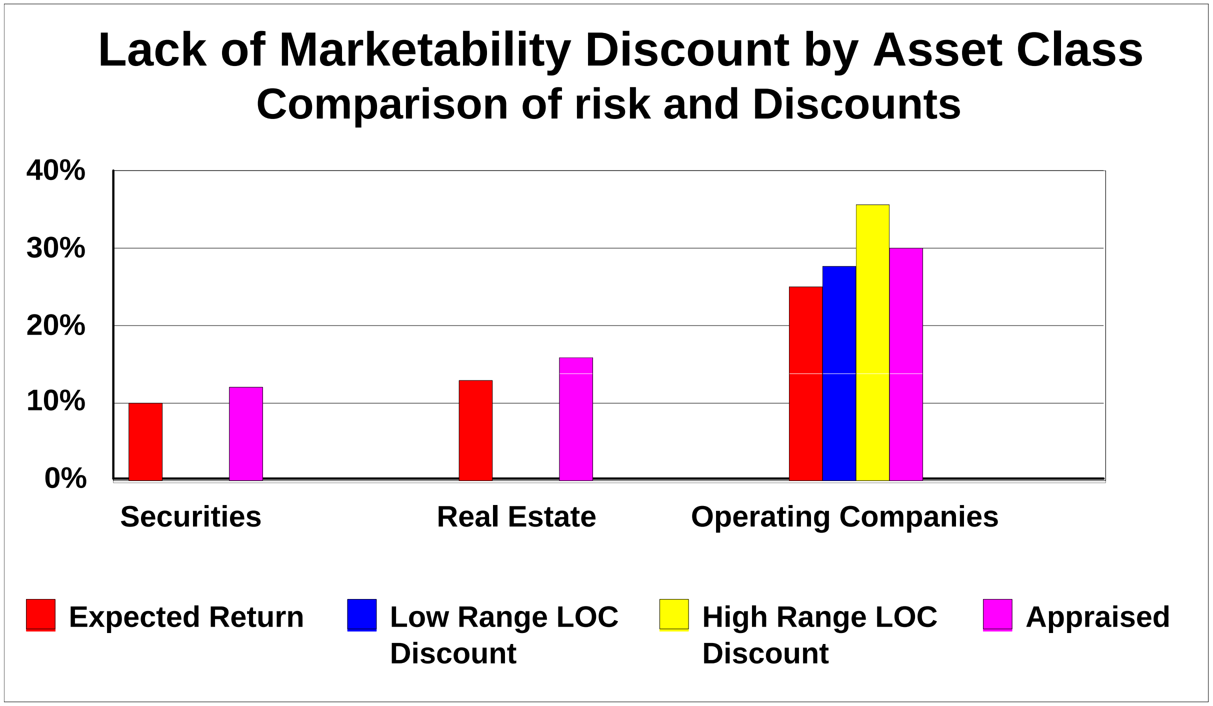
Lack of Marketability Discounts



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Measuring Lack of Marketability Discounts for Tier Assets

- Same studies were used for the operating company – nothing better available to date. Note: rates of return are:
  - 1/3 to 1/2 less than operating studies
  - 27.5% to 36% = normal rates of return
- Cash equivalents for securities must be used which makes the discounts lower

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Summary

DISCOUNT SUMMARY				
	ABC	Jewel	49% Interest	Total
DLOC	10%	0%	15%	25%
DLOM	5%	0%	15%	20%

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Mr. Herber is senior vice president and shareholder of Shenehon Company and managing director of its business valuation division. Shenehon is a commercial real estate and business valuation firm located in Minneapolis, Minnesota. Bill has over 25 years of valuation experience, specializing in intangible assets, fractional equity interests, holding companies, and special use properties. He is published in both local and national trade journals and has served as an instructor for numerous seminars. He has also testified as an expert witness in federal, state, and district courts, as well as for commission hearings and mediations. Mr. Herber received his BA in Accounting from the University of St. Thomas.

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