Cure for Declining Discounts:
Consider SLP Liquidation Activity

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Most valuation experts use data from the syndicated limited partnership (SLP) market to determine applicable valuations for family limited partnerships (FLPs) that hold real estate. However, in the past several years, there has been a noticeable decline in the discounts and yields for SLPs. Our analysis of 19 partnership studies that span more than 10 years shows that liquidation announcements, or liquidation-like behavior, decreases discounts by up to 20 percentage points. Conversely, distribution yields are not affected by liquidation. As SLPs continue to liquidate assets and announce liquidations, valuation practitioners must adjust market-observed discounts to account for the effect of liquidation in the valuation of FLPs.

Trends

Limited partnerships holding real estate are priced according to distribution yield or, if no distributions are being made, a discount to net asset value. Both valuation methods typically result in a value per unit that is lower than the investor's pro rata share of the net asset value. This decrease in value is the result of two impediments experienced by limited partners: (1) the lack of control over the entity and its assets and (2) the lack of marketability of the interest. The two concepts overlap slightly because a control investor would be able to force a sale of the assets and as a result, achieve liquidity.

The importance of liquidity in the pricing of syndicated partnerships is evidenced by the increase in market pricing over the last few years as more partnerships are announcing liquidity events. This trend does not extend to the FLP arena, however, where entities typically have a 20-to-30-year life span, with no intent of liquidation before the expiration of their term. A 1996 study by Steve Kam, Hans Schroeder and Curt Smith, "The Market Pricing of Syndicated LPs and the Valuation of FLPs,"[i] identified the four most important factors in determining pricing for SLPs: operating surplus, net asset value (NAV), initial dollars invested and cash distributions.[ii] Their study-based on data from June 30, 1992 through March 31, 1994- found little correlation between an entity's age and the partnership's price. This was not surprising: Liquidation among syndicated partnerships did not start in earnest until the late 1990s.

Other well-known studies of SLP pricing are published annually by Partnership Spectrum, a trade publication devoted to reporting on and analyzing the SLP market. Partnership Spectrum's 2003 study of partnership resale discounts found the two most important factors in determining the price-to-net-asset-value discount were an entity's ability to pay distributions and the degree of debt financing.[iii] Unfortunately, Partnership

Spectrum excludes from its studies all syndicated partnerships that have announced a near-term liquidation plan, so the effect on the pricing from a shorter investment period cannot be determined from the publication's work.[iv]

There appears to be a need for analyses of the effects of liquidations on SLP pricing for use in valuations.

Since 1996, Kam and Schroeder have studied the pricing of partnerships in the secondary market. They have now conducted 19 studies covering the period from June 30, 1992 through Dec. 31, 2002. That was approximately one study every six months.[v] Each study documented the financial performance, select ratios and pricing parameters of real estate holding SLPs.

Using the Kam and Schroeder studies, we examined the discount trends during the last decade. Clearly, discounts decreased dramatically during the past several years, implying that investors are paying more for partnership interests. (See "Distributing Partnerships, Price to NAV" and "Non-Distributing Partnerships, Price to NAV," page 48.) A similar trend is seen in the distribution yields that investors require from their partnership investments. Yields have decreased, indicating an increase in pricing levels. (See "Current Yield of Distributing Partnerships," page 48.)

There has been no fundamental change in the way these entities operate, perform or are managed that could explain the increase in valuations. The most important change in the partnership arena has been the numerous liquidation announcements.

Significant Factors

After analyzing the 19 Kam/Schroeder studies (dataset), we ruled out age as an important factor in pricing partnerships interests. A preliminary single-variable regression was performed to test the hypothesis that an older partnership, which would be closer to termination, would have a lower discount or yield. Ten partnerships from the 19th study were identified and their respective discounts were recorded from each of the 19 studies. In addition, the age of the partnership was documented for each study. Thereafter, a single variable regression was performed.

Our results showed the age of the partnership explained only 5 percent of the variation in the discount and 3 percent of the variation in the yield.

If the age of a partnership is not significant in explaining the variation in pricing, perhaps an announcement of asset liquidation is? For each of the real estate holding partnerships in the dataset, we determined the point in time, if applicable, when management announced a liquidation. We found a majority of general partners (GPs) began liquidating assets before making a formal announcement. To test the effect of these two factors, we created two dummy variables denoting: (t) the presence of a liquidation announcement, and (2) the presence of liquidation-like behavior (such as commencing a sale of assets), absent a formal liquidation announcement.

For the regression, we used data from all 19 partnership studies. In addition to the two binomial variables, we incorporated 15 different financial ratios and a handful of size measures as independent variables to determine which factors best explained the variability in the discount and yield. Because many of partnerships appear in several or all of the studies, we were able to mea- sure the effect on pricing as a result of an initiation of liquidation.

Liquidation-like behavior was found to be statistically significant in determining the magnitude of the discount in non-distributing and low-distributing partnerships. We defined low-distributing partnerships as partnerships that had a distribution yield of 6 percent or less. The coefficient for this variable was 20. This coefficient indicates that the discount to net asset value in non-distributing and low-distributing partnerships decreases by about 20 percentage points if the general partners are perceived to be in a liquidation mode.

It is our theory that for non- or low-distributing partnerships in which there is insufficient or no current distribution, an investor needs the liquidation proceeds to achieve the required rate of return. As a liquidation event gets closer in time, the time-value-of-money theory allows an investor to pay more to achieve the same internal rate of return. Therefore, we conclude that for non- or low-distributing partnerships in which the distribution yield is 6 percent or less, an investor incorporates the potential of liquidation proceeds in the pricing decision.

We also found certain distribution (Distribution/NAV) and cash flow ratio (Cash Flow/NAV and Cash Flow/book value) factors to be statistically significant in the pricing of non- and low- distributing partnerships. That is, the presence of cash flow and thus distribution capability appears to increase the attractiveness of the interest.

The announcement of liquidation or liquidation-like behavior was not found to be statistically significant in explaining the variation in the yield or the derivative discount, in partnerships where the investor was receiving a current distribution yield of 7 percent or more. We deduce that for interests with current yield, an investor is more interested in the continuation of the distributions and is not in need of immediate liquidation proceeds to achieve the required rate of return.

Distribution ratios and cash flow ratios also have a significant correlation to the yield. With yielding interests, an investor requires both distributions and the ability of the partnership to distribute as determined by the strength of the cash flow.

Valuing FLPs

How does this affect the valuation of family limited partnerships? Current market-based pricing must be adjusted to value real estate FLPs; otherwise, such interests could be overvalued for purposes of gift and estate tax. FLPs have never been an attractive investment vehicle for outside investors: They are typically poorly diversified and management is often performed by individuals who are not trained investment professionals. There also can be restrictions on the transfer of the interest. As a result, an interest in a FLP is less attractive than its counterpart in the syndicated limited partnership market. FLPs, there- fore, should be priced lower and have a greater internal rate of return.

For many years, pricing data from the syndicated limited partnership market has been a good proxy for the valuation of FLPs. Now, though, the differences between the two entities overshadow their similarities at least when analyzing the non-distributing segment. If the valuation industry continues to value FLPs with a low-distribution expectation, using data from the syndicated market, adjustments must be made to account for the differences. Clearly, the effect of near-term liquidity is affecting value in the minds of investors. But, when valuing a low- distributing FLP, no such immediate or even medium-term liquidity is in sight. Therefore, valuation experts must adjust the discount indications to account for the difference. Our research shows that the addition of up to 20 percentage points can be justified when a comparable entity has commenced the sale of its assets.

What about FLPs with strong distribution records? Our analyses have not found a relationship between liquidation of assets and magnitude of yield in partnerships when the yield is 7 percent or more. Apparently, investors are more concerned with current income than the possibility of proceeds from liquidation of assets. Consequently, when valuing FLPs with strong distribution attributes, we cannot suggest an adjustment is appropriate. But we can conclude that, for purposes of this type of analysis, only syndicated LPs with yields greater than 7 percent should be used. Any entity with a lower yield is probably valued on a discount to NAV basis and is subject to the liquidation adjustment.

Recommendations

It is important that valuation professionals adjust their approach not only to incorporate changes in market pricing, but also to accurately account for any differences between the market place and the subject entity.

- *First, they should use comparable entities that have not had a liquidation announcement.* This will ensure a clean sample. Alternatively, to the extent that data is available, they should determine the increase in price as a result of liquidation announcements or liquidation-like behavior, adjusting the value indication to a pre-announcement value. As our analysis has shown, the presence of a liquidation announcement decreases the discount by up to 20 percentage points.

- *Second, they should review pricing information over time.* If there are noticeable differences, they should perform a multiple regression analysis to see which factors most affect the pricing of the entities. While our analysis showed only a small correlation between the date of the study and the magnitude of the discount, this factor warrants further examination. Alternatively, if time is not a significant factor in determining the magnitude of the discount, an argument could be made for using data from longer time periods rather than the most recent pricing data.

- *Lastly, they should consider using other valuation approaches as a complement to the LP data.* While we firmly believe that data from the syndicated LP market is the best proxy available for pricing FLPs, we recognize that it will not be available in a few years. The diminution of the SLP data is a result of liquidations and subsequent winding down of the traded entities. While valuation experts can continue to use historical pricing, they should augment this valuation method with some alternative valuation indications.

Endnotes

[i] Steve Kam, Hans Schroeder, Curt Smith, "The Market Pricing of Syndicated LPs and the Valuation of FLPs," *Trust & Estates*, February 1996, p.35-45·

[ii] Steve Kam, Hans Schroeder and Curt Smith, "The Market Pricing of Syndicated LPs and the Valuation of FLPs," *Trust & Estates*, February 1996, p. 43·

[iii] Spencer Jeffries, "Partnership Re-sale Discounts Holding Up," *Partnership Spectrum*, May/June 2003, p. 4·

[iv] Jeffries notes that the announcement of near-term liquidation plans can have a dramatic impact on how the partnership's units are priced in the secondary market.

[v] The 20th study is underway and will include the period from Jan. 1, 2003 through June 30, 2003.