

Valuing Tiered Partnership Structures



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Looking at Tiered Discounts through the Astleford Case

BVR What It's Worth Questions: TC-Questions@BVResources.com
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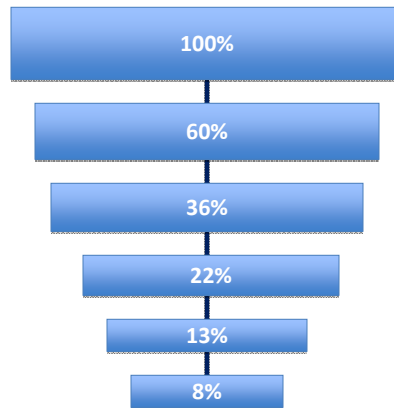
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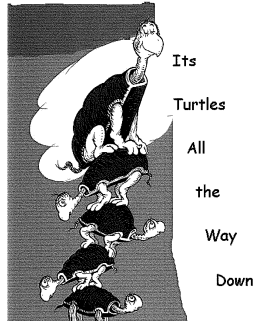
Valuing Tiered Partnership Structures

Tiered Entities and Discounts

Disappearing Value at a 40% Discount



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Marriott River Center
San Antonio, Texas

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Tiered Discounts

A look at Two Publicly Closed End Funds Exhibiting Tiered Discounts:

- Equus Total Return
- Cohen & Steers



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Equus Total Return, Inc.

Discount from NAV – 30-40%

The Fund currently invests, and will continue to invest, in private, small or new companies that may be in their early stages of development. Investments in these types of companies involve a number of significant risks.

“Investments in small capitalization companies present certain risks that may not exist to the same degree as investments in larger, more established companies and will cause such investments to be volatile and speculative.”



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Equus Total Return, Inc.

Discount from NAV – 30-40%

The Adviser receives a base advisory fee at an annual rate of 2% of the net assets of the Fund...as well as incentive fees:

- (i) 20% of the excess of the Fund's net investment income that exceeds a hurdle rate of 8% of the Fund's netassets,
- (ii) 20% of the Fund's net realized capital gain less unrealized capital depreciation, paid on an annual basis.



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Cohen & Steers Closed-End Opportunity Fund, Inc.

Discount from NAV 0% -5%

Investments in securities that are listed on the New York Stock Exchange. Readily marketable securities traded in the over-the-counter market, are valued at the official closing prices as reported by sources as the Board of Directors deem appropriate to reflect their fair market value.



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Cohen & Steers Closed-End Opportunity Fund, Inc.

Discount from NAV 0% -5%

Investment Management Fees

The investment manager receives a fee of 0.95% of the average daily net assets of the Fund. The investment manager has contractually agreed to reimburse the Fund so that its total annual operating expenses do not exceed 0.95% of the average daily net assets.



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Tiered Entity Valuation Components

KEY VALUATION FACTORS

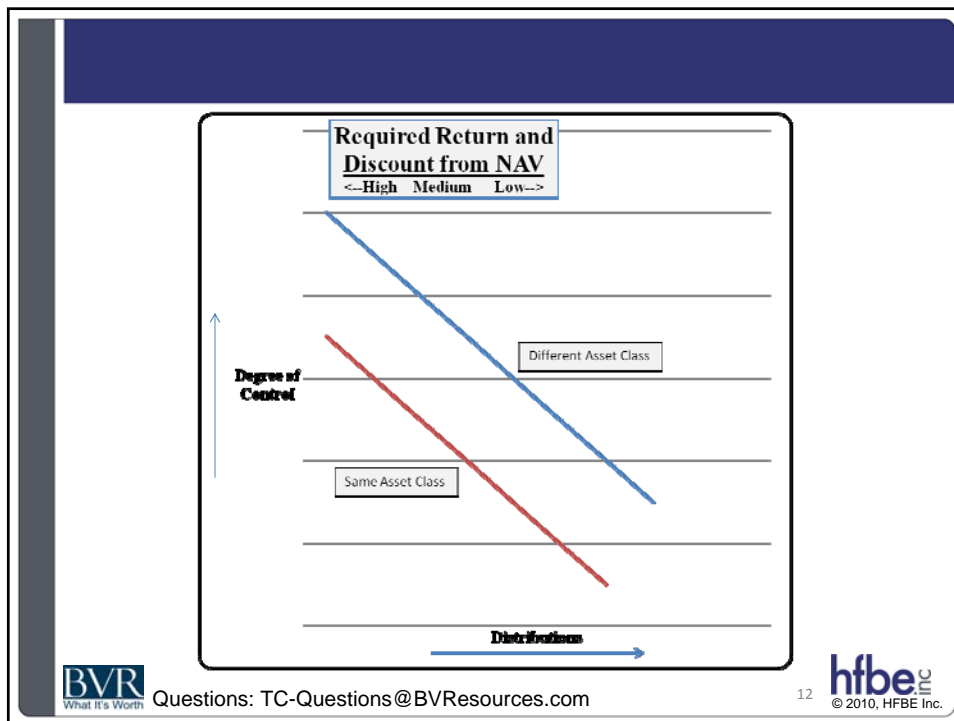
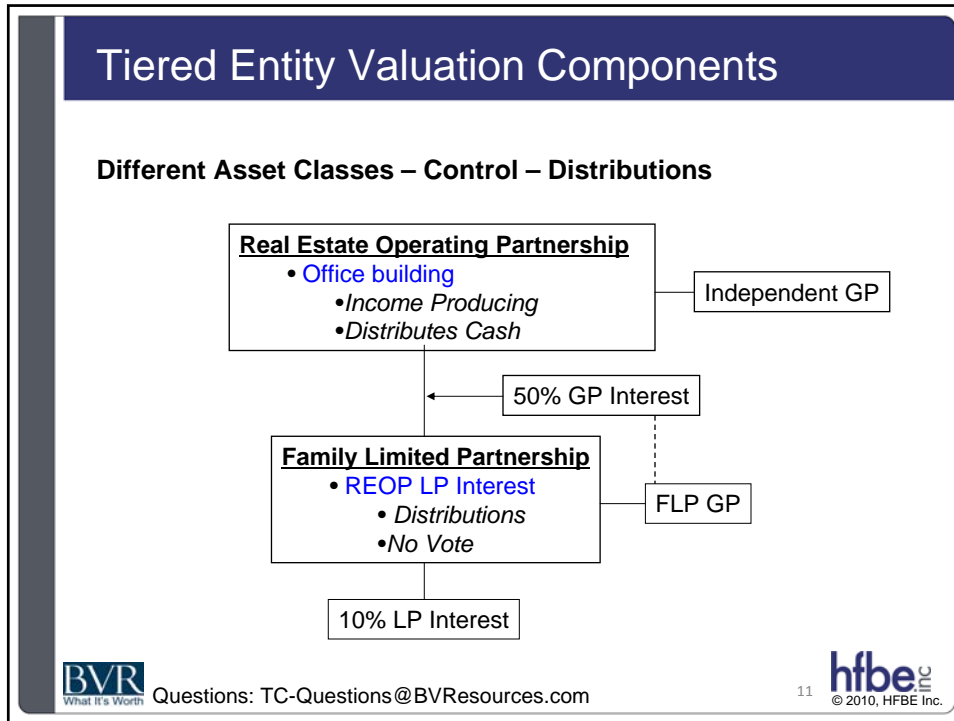
- Asset Class – Expected Returns
- Financial Risk
 - Leverage
 - Profitability
 - Specific Risk – e.g., Key Person, Customer Concentration
- Governance Risk
 - Type of interest – e.g., LP, GP or Assignee
 - Control – None, Minimal, Equal, Majority and Total
 - Term of Entity Life
 - Liquidity – Transferability, Withdrawal and Liquidation
- Distributions
 - Full or partial payout
 - No payout
 - Asynchronous



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Valuing Tiered Partnership Structures



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Overview

General Orders of Magnitude where Operating Partnership holds Moderately Volatile Assets*

	(a)	Operating Partnership				Investment Partnership		Combined
		LOC	LOM			LOC	LOM	
No Distributions	(a)	10%	35%	Different Asset Class	Different General Partner	5%	18%	54%
Distributions		5%	25%	Different Asset Class	Different General Partner	3%	13%	39%
No Distributions		10%	35%	Different Asset Class	Same General Partner	3%	12%	50%
Distributions		5%	25%	Different Asset Class	Same General Partner	1%	6%	34%
No Distributions		10%	35%	Same Asset Class	Different General Partner	3%	9%	48%
Distributions		5%	25%	Same Asset Class	Different General Partner	1%	6%	34%
No Distributions		10%	35%	Same Asset Class	Same General Partner	2%	6%	46%
Distributions		5%	25%	Same Asset Class	Same General Partner	1%	4%	32%

Note:

Every partnership and tiered investment is fact specific. The above is intended as a general guideline. There are many other factors affecting valuation besides the ones described.

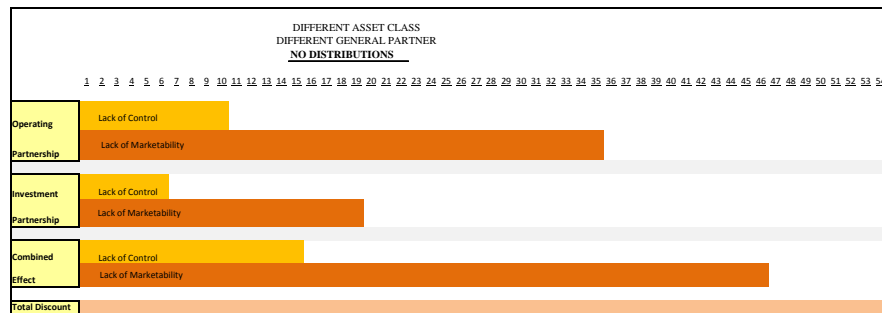
* This scenario does not address highly risky assets, duress, insolvency or highly leveraged situations.
(a) Distributions are assumed to be full payout of cash flow or none.



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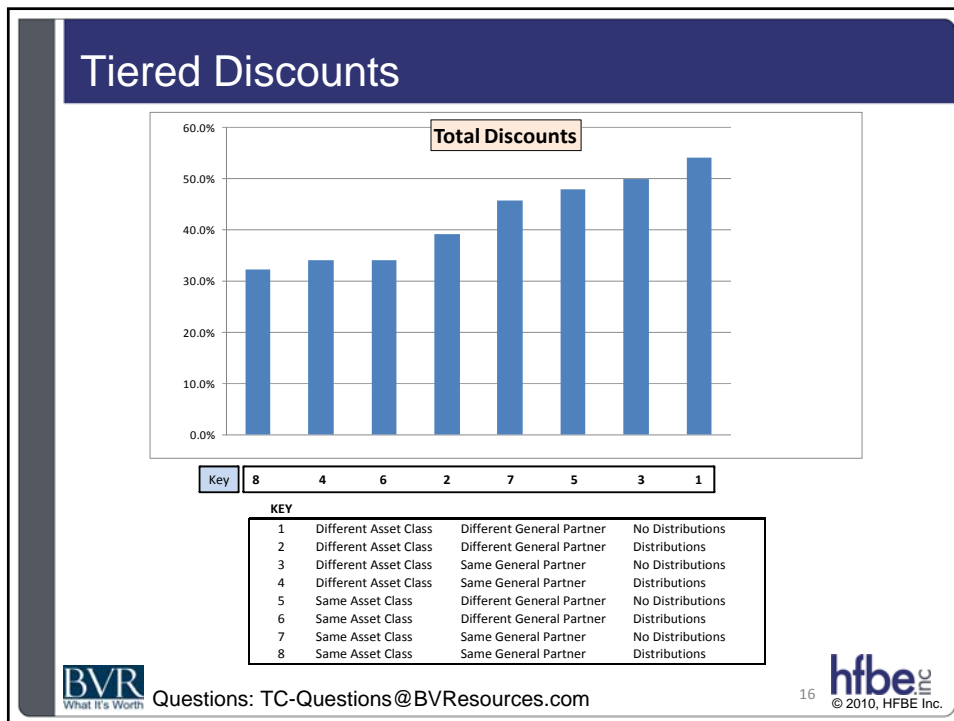
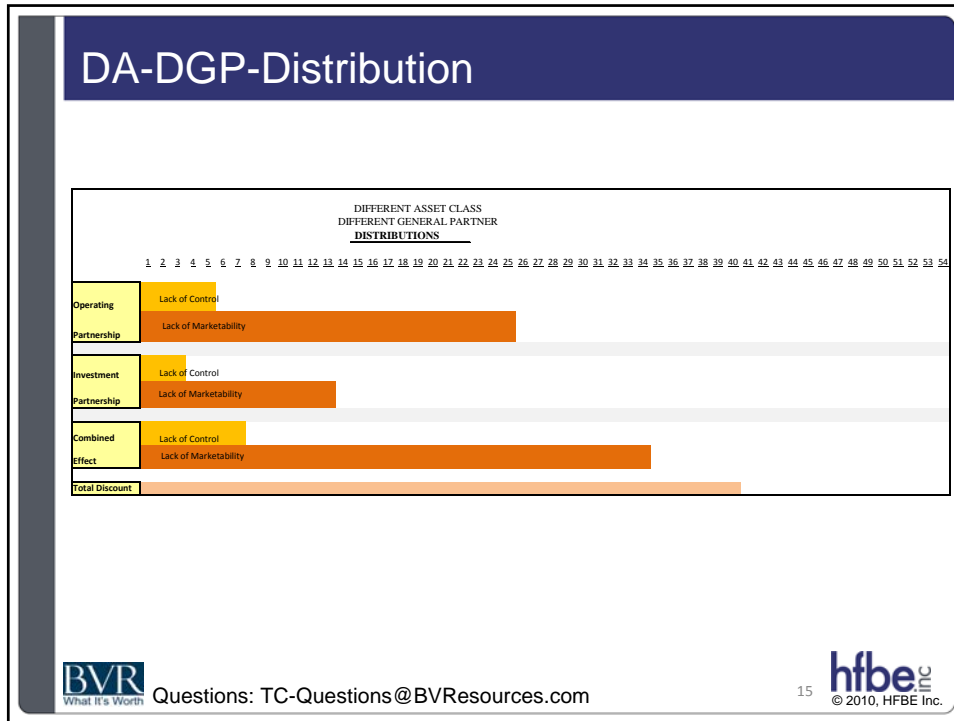
DA-DGP-No Distribution



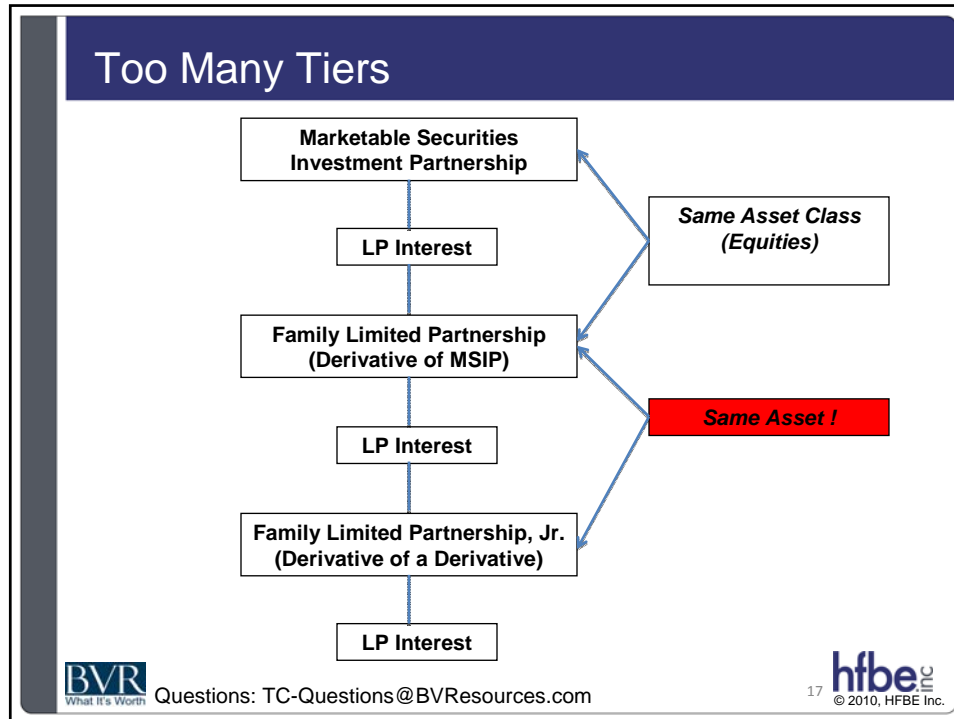
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Valuing Tiered Partnership Structures



Astleford v. Commissioner

- In 1970, MG and Richard T. Burger formed Pine Bend Development Co. (Pine Bend) as a Minnesota general partnership
- MG and Mr. Burger were each 50-percent general partners in Pine Bend

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Valuing Tiered Partnership Structures

Astleford v. Commissioner

- Under provisions of the AFLP agreement, AFLP's net cash flow was to be distributed annually among the partners
- The LPs were not entitled to vote
- No outside party could become a partner in AFLP without consent of petitioner as general partner
- A LP could not sell or transfer any part of his or her AFLP limited partnership interest without consent of petitioner
- No real property interest held by AFLP could be partitioned without consent of petitioner



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Astleford v. Commissioner

- AFLP's asset value was growing at 7%/yr
- Debt (50% of NAV) had interest rate of 7.5%
- Expenses +/- 250 basis points
- 10% cash payout on NAV



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Astleford v. Commissioner

“Given the minimal risk involved in selling the Rosemount property over 4 years, the fact that most of the acreage was already leased, and the 9.2-percent return on equity earned by southeastern Minnesota farmers in 1997, we conclude that the appropriate present value discount rate to apply to the projected cashflow* from the Rosemount property over 4 years is 10 percent”

- Judge Swift

 * From assumed sale of the asset
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Astleford v. Commissioner

- AFLP controlled the 50% Pine Bend GP Interest
- The majority of the AFLP assets was real estate owned directly by the partnership
- AFLP generated a current return of 10% annually.

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Astleford v. Commissioner

Pine Bend

Because petitioner was AFLP's sole general partner, petitioner was essentially in the same management position relative to the 50-percent Pine Bend interest whether she is to be viewed as having transferred to AFLP a Pine Bend assignee interest (and thereby retaining Pine Bend management rights).

or

as having transferred those management rights to AFLP via the transfer of a Pine Bend general partnership interest (in which case she reacquired those same management rights as sole general partner of AFLP).

Either way, after December 1, 1997, petitioner continued to have and to control the management rights associated with the 50-percent Pine Bend general partnership interest.



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Astleford v. Commissioner

- Judge Swift determined a combined discount of 30% for the 50% Pine Bend GP interest held by AFLP
- Based off of the discount of 30% for RELPs
- Minority interest in AFLP has no control
- The Pine Bend interest has significant control
- The Pine Bend interest is semi-liquid based on its withdrawal rights



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Valuing Tiered Partnership Structures

AFLP Valuation as of December 1, 1997

Pine Bend GP Interest

Pine Bend assets Cash	\$213,159	
Rosemount Property	\$3,308,575	
Stipulated NAV of other property	\$190,000	
Total NAV of Pine Bend	\$3,711,734	
Less 30-percent combined discount	(\$1,113,520)	
Total discounted Pine Bend NAV	\$2,598,214	
FMV of 50% Pine Bend GP interest		\$1,299,107

NAV of other AFLP property		\$10,032,271
AFLP NAV		\$11,331,378
Less: Discount for Lack of Control – 17.47% MMIV		(\$1,979,592)
MMIV		\$9,351,786
Less: Discount for lack of Marketability – 22%		(\$2,057,393)
Fair Market Value		\$7,294,393
Combined Discount from AFLP NAV		35.6%
Combined Discount including Pine Bend discount		38.6%



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Astleford v. Commissioner

Distributions as a Key Factor

Petitioner's expert also stated that the higher an RELP's cash distribution rate the lower the investor risk should be, which in turn would suggest a lower trading discount.

“Because AFLP's cash distribution rate of 10 percent was significantly higher than the 6.7-percent average cash distribution rate observed in his RELP comparables, under petitioner's expert's own approach his recommended AFLP lack of control discounts should be lower than the 38-percent average trading discount he observed in his RELP comparables.”



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Astleford v. Commissioner

- Judge Swift found the 10% distribution rate of AFLP persuasive in lowering the discount
- That is, DISTRIBUTIONS are a KEY FACTOR



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AFLP Valuation as of December 1, 1997

If Pine Bend was only AFLP Asset?

Pine Bend NAV	\$3,711,734
NAV of 50% GP Interest	\$1,855,867
Less: Combined 30% Discount	<u>(\$556,760)</u>
Pine Bend 50% GP Interest (discounted by 30%)	\$1,299,107
Less Discounts for lack of control @ 17.47%	<u>(\$226,954)</u>
MMIV	\$1,072,153
Discount for lack of marketability	<u>(\$235,874)</u>
FMV	\$836,279
Combined Discount	54.9%



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Astleford v. Commissioner

- Using the same mathematics, the implied IRR for the Pine Bend assets is 22.2%
- This is clearly too high
- Here, Judge Swift's discount is too great



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If Pine Bend was AFLP's Only Asset

Total Assets	\$5,642
Debt (@ 52% NAV)	(\$1,930)
Int Exp	(\$145)
Op Ex	(\$85)
NAV	\$3,712
Payout	\$371
Investment	(\$1,674)
IRR-20 yrs.	22.2%
50% NAV	\$1,856
FMV	\$837

Assumptions

NAV Payout	10.0%
Exp Factor	1.5%
Int Cost	7.5%
Growth	7.0%
Discount	54.9% *

* Implied discount is 30% on Pine Bend GP interest plus 17.47% for AFLP minority interest discount and 22% for lack of marketability discount.



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Pine Bend IRR at Judge's Discount – No Distributions

Total Assets	\$5,642
Debt (@ 52% NAV)	(\$1,930)
Int Exp	(\$145)
Op Ex	(\$85)
NAV (Pre-Discount)	\$3,712
Payout	\$0
Investment	(\$2,598)
IRR-20 yrs.	7.6%
50% NAV	\$1,856
FMV	\$1,299

Assumptions

NAV Payout	0
Exp Factor	1.5%
Int Cost	7.5%
Growth	7.0%
Discount	30.0%



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AFLP Valuation as of December 1, 1997

Valued without Pine Bend

AFLP Other Properties	\$10,032,271
Less Discounts for lack of control @ 17.47%	(\$1,752,638)
MMIV	\$8,279,633
Discount for lack of marketability	(\$1,821,519)
FMV	\$6,458,114
Combined Discount	35.6%



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Astleford v. Commissioner

“We look simply to the difference in average discounts observed in the private placements of registered and unregistered stock based on the premise that the difference so observed represents pure liquidity concerns...”

See *McCord v. Commissioner*, supra at 385; *Lappo v. Commissioner*, supra. According to two studies respondent's expert cited, the difference was approximately 14 percentage points



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Astleford v. Commissioner

- Implications of Astleford discounting
 - If the Combined discount of 35.6% for AFLP is about right
 - AND, since AFLP had a current yield of 10%
 - THEN, the Combined discounts in *McCord* and *Lappo* were clearly too low since these partnerships had little or no current yield



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Astleford v. Commissioner

- AFLP NAV was \$11,331,000
- A Combined discount of 35.6% equates to an investment price of \$7,294,000
- With a current payout of 10% and 7% growth IRR over 20 years is 17.7%
- **Thus, Judge Swift's discount looks reasonable**



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AFLP Rate of Return at Reported Discount

Total Assets	\$17,223
Debt (@ 52% NAV)	(\$5,892)
Int Exp	(\$442)
Op Ex	(\$258)
NAV	\$11,331
Payout	\$1,133
Investment	(\$7,297)
IRR-20 yrs.	17.7%*
30% NAV	\$3,399
FMV	\$2,189

Assumptions

NAV Payout	10.0%
Exp Factor	1.5%
Int Cost	7.5%
Growth	7.0%
Discount	35.6%

* If no distributions, discount would have to be 75% to maintain this rate of return.



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Why REIT LOC Method is Wrong

“We agree with respondent’s expert that in order to estimate or quantify an appropriate lack of control discount from REITs...

trading prices one should eliminate or reverse out the liquidity premium inherent in REIT trading prices”

- Judge Swift



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Why REIT LOC Method is Wrong

- Following *McCord*, the LOC discount was based on REIT studies
- This methodology is just plain **WRONG.**
- It was wrong in *McCord* and it is wrong in *Astleford*



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Valuing Tiered Partnership Structures

Why REIT LOC Method is Wrong

- Why do REITs historically trade at such low discounts relative to Closed End Funds?
 - REITs have high current yield and appreciation potential
 - CEF current return is “manufactured”—significant percentage is a Return of Capital



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Why REIT LOC Method is Wrong

- Looking for minority interest discount of a Liquid interest
 - When we determine LOC discount by use of Closed end Funds, we are using a MARKETABLE price – we do not back out the “liquidity premium”
 - When valuing an operating company and determining the minority interest discount by the “inverse of the control premium” the benchmark is a LIQUID price
 - Why is a REIT any different than the above?



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Valuing Tiered Partnership Structures

The (fuzzy and confused) REIT LOC Methodology

1. Find discount (or premium) of REIT market price per share as % of NAV
2. Deduct the “Liquidity Premium” of publicly traded REIT shares
 - a. Use inverse of Hertz and Smith 14% discount for registered shares (inverse is 16.27%)
 - b. Add REIT discount
 - c. In Astleford: $1.2\% + 16.27\% = 17.47\%$



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Why REIT LOC Method is Wrong

Do Stock Prices Really Reflect Fundamental Values? The Case of REITs
William M. Gentry, Charles M. Jones, and Christopher J. Mayer
NBER Working Paper No. 10850
October 2004

“Real estate investment trust (REIT) stock prices deviate substantially from net asset values (NAV). The closed-end fund literature has some similar findings on stock price deviations from fundamental value, but compared to closed-end funds REITs are much larger and have much higher insider and institutional ownership.”



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