

# A FAMILY LIMITED PARTNERSHIP (FLP) VALUATION EXAMPLE

Linda B. Trugman CPA/ABV,  
MCBA, ASA, MVS



## FLP VALUATION PROCESS

- What are you valuing?
- Obtain necessary documents
- Review and analyze agreement
- Analyze financial data
- Determine and apply appropriate methodology
- Determine appropriate discounts and premiums

## WHAT TO LOOK FOR IN THE AGREEMENT

- A provision (term-of-years provision) in the partnership agreement that the partnership shall continue to exist for a definite term-of-years, unless it is dissolved or liquidated prior to this date.
- No guarantee by the managing general partner or general partners of the return of any partner's capital contributions, nor any allocations of profits or losses nor any distributions of distributable cash (not even enough to cover the annual taxes of the partners).
- Approval rights of limited partners required for certain major decisions, otherwise limited partners and assignees are excluded from participation in management.

## WHAT TO LOOK FOR IN THE AGREEMENT

- How the election of new managing general partners is accomplished.
- A provision that distances the limited partners and assignees from the assets of the FLP.
- The managing general partner(s)/general partner(s) right to determine distributable cash.
- Capital call provision obligating partners and assignees.
- Limitations on the voluntary and involuntary transferability of general partner, limited partner and assignee interests.

## WHAT TO LOOK FOR IN THE AGREEMENT

- The presence of rights of first refusal.
- A transferee or assignee of an interest in the partnership will not become a substituted limited partner unless approved by the consent of all partners.
- Whether the managing general partners or general partners are required to make a IRC Section 754 Election.
- Limitations on the right of a limited partner and assignee to withdraw from the partnership prior to the expiration of its stated term.
- Provisions for dissolution of the partnership mirrors the provisions of state law.

## APPROPRIATE METHODOLOGY

- Revenue Ruling 59-60 states:
  - (a) ... in general, the valuation analyst will accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public, conversely, in the investment or holding type of company, the valuation analyst may accord the greatest weight to the assets underlying the security to be valued.

## APPROPRIATE METHODOLOGY

(b) The value of the stock of a closely held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock. For companies of this type the valuation analyst should determine the fair market values of the assets of the company... For these reasons, adjusted net worth should be accorded greater weight in valuing the stock of a closely held investment or real estate holding company, whether or not family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend paying capacity.

## ASSET-BASED APPROACH

- **Adjusted Book Value Method**
  - Obtain fair market value of all assets and liabilities on the balance sheet and apply appropriate discounts (for lack of control and marketability).

## INCOME APPROACH

- Determine cash flow available to partners, and capitalize or discount as appropriate.
- Apply discount for lack of marketability (no discount for lack of control necessary as cash flow capitalized or discounted is the amount available to the minority owner, and therefore, the result is a minority value).

# INCOME APPROACH – DISCOUNT RATE

<i>Appraisal Date Long-Term Treasury Bond Yield</i>		<u>5.01</u>
<i>Real Estate Risk Premium</i>		
	1994-2005 Publicly Held LP Return	18.602
	1994-2005 Government Bond Income Return	<u>-5.883</u>
<b>Average Market Return</b>	=	12.72
<i>Adjustments for Other Risk Factors</i>	+	<u>3.00</u>
<b>Discount Rate for Net Cash Flow</b>	=	<u>20.73</u>

## CAPITALIZATION RATES

<i>Discount Rate for Net Cash Flow</i>		<u>20.70</u>
<i>Growth Rate</i>	-	<u>3.00</u>
<b>Capitalization Rate for Net Cash Flow</b>	=	<u>17.70</u>
<b>Rounded</b>	=	<u>18.00</u>



## INCOME APPROACH – DISCOUNT RATE

- Sources of information for discount rate for real estate
  - *Risk Free Rate - Federal Reserve, Market Yield on U.S. Treasury Securities at 20-year constant maturity as of valuation date*
  - *Rate of Return Study, Partnership Profiles, Inc.*
  - *Long-Term Government Bonds: Income Returns, Stocks Bonds Bills & Inflation - Valuation Edition 2006 Yearbook.*
  - *Valuation analyst's judgment based on the analysis discussed throughout the report.*

## INCOME APPROACH – DISCOUNT RATE

- Sources of information for discount rate for marketable securities
  - Use dividend yields from closed-end funds as a possibility
  - Difficulty in finding funds that match the subject company's portfolio

## INCOME APPROACH - ISSUES

- Revenue Ruling 59-60 suggests an asset-based approach when valuing a holding company
- However, a minority owner cannot force the sale of the underlying assets of a business, and although the appraiser applies a discount for lack of control to account for this (among other factors), does the discount truly account for the inability of the minority owner to obtain the value of the underlying assets?

## INCOME APPROACH - ISSUES

- There is generally no plan to sell the assets of an FLP before termination, which is generally at least 20 to 30 years from the date of inception. Therefore, it seems that if a FLP generates income, this reflects an actual return to the minority owner, and should be considered in the valuation process (in other words – income approach).

## INCOME APPROACH - ISSUES

- Very often, the investment earnings or net rental income is very low, but the growth in the assets is large. Unless there is a plan to sell the assets at a definitive time in the future, the return to the minority owner is a low level of income that does not truly reflect the value of the assets.

## INCOME APPROACH - ISSUES

- Another potential problem that exists is the selection of a discount or capitalization rate, especially if the holdings are marketable securities. Although market-derived rates of return are available, they are usually derived from ownership of the underlying assets. However, the valuation assignment is to value an interest in a holding company, and therefore, adjustments must be made to the market-derived rates to adjust for risk.

## MARKET APPROACH

- Determine valuation multiples by looking for comparable publicly traded interests. The appropriate multiple could be price to NAV (net asset value), adjusted for the risks associated with your specific valuation assignment.
- From a practical standpoint, this is generally the same as the asset-based approach.

## VALUATION ADJUSTMENTS – DLOC

- **Marketable Securities –**
  - Use discount from NAV from Closed-End Funds (*Barron's*, Morningstar)
  - Pick discounts from the appropriate group of funds – domestic, foreign, bonds, etc.
- **Real Estate –**
  - Use discount from NAV from REITS and Real Estate Limited Partnerships
  - Match funds with type of property – land, commercial, warehouse, etc.

# VALUATION DISCOUNTS – DLOC

- Calculate weighted average discount

	<b>% of Portfolio</b>	<b>x</b>	<b>Discount</b>	<b>=</b>	<b>Weighted Average</b>
<i>Cash, Money Market and U.S. Gov't Bond Funds</i>	4.85%		10.3		0.50%
<i>U.S. Common Stocks</i>	17.95%		6.9		1.24%
<i>Income &amp; Preferred Stocks</i>	1.83%		8.4		0.15%
<i>Municipal Bonds</i>	66.08%		3.6		2.38%
<i>Corporate Bonds</i>	0.45%		7		0.03%
<i>High Yield Bond Fund</i>	0.63%		3.8		0.02%
<i>World Equity Funds</i>	7.20%		5.9		0.42%
<i>U.S. Mortgage Bond Funds</i>	0.00%		9.3		0.00%
<i>World Income Funds</i>	0.19%		7		0.01%
<i>Real Estate</i>	0.82%		15.5		0.13%
	<b>100.00%</b>				<b>4.89%</b>
			<b>Rounded</b>		<b>5.00%</b>

## VALUATION ADJUSTMENTS – DLOC

- Court cases frown on adjusting these discounts
  - By selecting only certain funds, the discount is already distorted
  - There is nothing to base an adjustment on
- However, if the valuation analyst believes it is appropriate and supportable, then the discount should be adjusted based on facts and circumstances

## VALUATION ADJUSTMENTS – DLOM

- Restricted Stock Studies
- Pre-IPO Studies
- Other methodologies
  - Stock option modeling
  - Ashok Abbott's lack of liquidity
  - LEAPs

## VALUATION DISCOUNTS – DLOM

- Benchmarking is frowned on, but factors to consider from The Agreement are as follows:
  - With some exceptions, a general partner, limited partner or an assignee may not transfer all or any part of his or her interest without the prior written consent of the general partners, which consent may be given or withheld at the discretion of the general partners.
  - A transferee of an interest in a FLP shall only be entitled to the rights of an assignee unless the consent of all general partners and a majority in interest of the limited partners is given to make the transferee a substitute limited partner.
  - No partner or assignee shall have the right to withdraw from the FLP prior to its dissolution and liquidation.
  - No partner or assignee may withdraw or reduce his or her capital contribution or capital account without the consent of the general partner.



## VALUATION ADJUSTMENTS - DLOM

- *Mandelbaum* factors:
  - Financial statement analysis
  - Company's dividend policy
  - Nature of the company, its history, its position in the industry and its economic outlook
  - Company's management
  - Amount of control in transferred shares
  - Restrictions on transferability of stock
  - Holding period for stock
  - Company's redemption policy
  - Costs associated with going public

## VALUATION ADJUSTMENTS – DLOM

- **Factors that would reduce the DLOM:**
  - Minimal volatility in the value of the underlying assets
  - Above average expectations for future yield
  - A proven and stabilized history of income
  - Certainty of distributions or expectation of capital appreciation
  - Limited time period on restriction of ability to sell the interest
  - Favorable outlook for future growth of the entity

## VALUATION ADJUSTMENTS – DLOM

- **Factors that increase the DLOM:**
  - High degree of volatility in the value of the underlying assets.
  - Questionable ability to generate a satisfactory return on assets.
  - Inability to generate sufficient earnings for distributions or to support future growth in operations.
  - Small size in relation to other investments and lack of diversification.
  - Involvement in industries or activities viewed unfavorably by the investing public.

**THANK YOU!**

**ANY QUESTIONS?**

