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Valuing Fractional Interests in a Vacation Home: A Conversation With Eric Nath

On May 10, 2010, Judge Halpern of the U.S. Tax Court decided on *Ludwick v. Commissioner* (T.C. Memo 2010-104), a case that involved a 50% undivided interest in a vacation home on Hawaii's Big Island. The application of valuation discounts to undivided half-interests in real property is a long-contested issue, so BVU approached Eric Nath, a well-known expert in fractional and minority interest valuations, to comment on the case.

BVU: Eric, what did you find interesting about the *Ludwick* case?

Eric Nath: There were several interesting things about that case. On a personal level, it came out at a time when I was finishing a valuation of a fractional interest in a very similar property in one of the high-end Oregon resort communities. In the course of my analysis for that case I discovered that there was an active market for fractional interests in vacation homes in this particular resort, which surprised me because there are not many areas I've run into where an active fractional-interest market exists. I was curious to find out if there was a similar marketplace for fractional interests in vacation home properties on the Big Island, and whether this had entered into the appraisers' analysis in *Ludwick.*

Having been a partition referee, I was also intrigued to see if and how the appraisers in *Ludwick* dealt with the issue of partition. This can be a very important factor to consider in valuing fractional real property interests. In my experience, few people really understand what happens in a partition lawsuit, so they base their analysis on incorrect assumptions that can distort the answer.

The *Ludwick* case was also affected by various machinations that went on prior to trial. Perhaps because of this, it is my impression that some things were either ignored or overemphasized in that case, which would seem to make this decision pretty unreliable for appraisers looking to court precedent as a guide in these types of cases.

Finally, it's interesting to consider how a tenancy in common (TIC) agreement affects value. For example, in the *Ludwick* case there was a TIC agreement, but for the fractional I was valuing there was no TIC agreement. You would think that a TIC agreement, which restricts the right to sell or partition, would have a chilling effect on the marketability of an interest like this. But in fact the reverse actually appears to be true where a market for fractional interests has developed.

Q: Tell me a little bit more about the research you've done on the markets for fractional real property interests.

A: I have valued probably 50 or 60 fractional interests in various states in the last 10 or 15 years, and I always do original research on the court system in the county in which the property is located, as well as research on the potential market for whatever interest it is that I'm valuing. For the most part, markets do not exist for fractional interests. However, there are a few pockets where creative individuals have developed a market of sorts. In San Francisco, because of the existence of rent control, there is a unique marketplace for certain types of small multifamily rental properties where individuals will syndicate the purchase of a building, with the idea of converting the property to condominiums.

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Subsequently, one or more of the fractionals may change hands before the conversion has commenced. These types of interests tend to trade somewhere between the value of the property as apartments and the value of the property as converted to condominiums. In essence, investors are buying an arbitrage opportunity.

Of course, there is also the (previously very active) market for investment-grade TIC interests that have been syndicated by many of the 1031 exchange-type outfits.

The Oregon resort property I was working on had what I consider to be a reasonably developed marketplace for fractional interests. Apparently, the market arose in response to the fact that many of the properties are very expensive, and buying a fractional interest allows individuals to avoid paying full price for a property they might use only two or three months out of the year and either leave it vacant or try to rent it out. Buying a one quarter interest in a $2 million house for $500,000 solves that problem. One of the beauties of this type of arrangement over a timeshare is that you own a deeded interest and have the opportunity to participate in the appreciation of the value of the property. My research suggested that prior to the economic meltdown of 2008 some of these fractional interests were trading at premiums to the value of the property as a whole.

According to the brokers I spoke with, fractionals are now trading much closer to pro rata. The main condition upon which a transaction depends is the existence of a tenancy in common agreement! Without a TIC agreement a fractional interest is simply not salable in this particular resort. In addition to specifying the process by which the property is managed (including occupancy schedule), the TIC agreement gives the other owners a right of first refusal in the event an owner wishes to sell, and also prohibits partition until the other owners have had a chance to buy the interest. Apparently this structure provides the necessary assurance for people to feel comfortable owning a partial interest in the real estate.

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When *Ludwick* came down I thought it would be interesting to see if a similar market had developed on the Big Island. I contacted a broker in Hawaii and found that, while there is currently a similar market for fractionals, it is not as highly developed as in the resort I was dealing with in Oregon. Furthermore, the fractional interest market on the Big Island has only really evolved in the last five or six years. Since the transaction which gave rise to the valuation in *Ludwick* occurred in 2002, it wouldn't have been a factor in that case!

I didn't investigate this enough to know at what price point the marketplace for fractionals in Hawaii is trading, but if it is anything like Oregon there might be no discount at all for the *Ludwick* interest if valued today.

Being in California I have also had occasion to value partial interests in vacation homes in the Tahoe area in the past. The truism about all real estate being local is certainly mirrored in the fractional-interest marketplace. Tahoe's fractional-interest market seems to be even less well developed than Hawaii's, with interests in large multiunit high-end resort properties being the principal type of fractional that is available to a prospective owner. Reportedly, most of the transactions in single-family vacation homes have not worked out very well, and there still is not a great deal of activity in this respect. Maybe California people just aren't as laid-back or as enlightened as the people in Oregon, I don't know!

Q: So, bottom line, it doesn't appear that there are any rules of thumb, and you really need to do your research.

A: There really are very few rules of thumb when valuing a fractional interest. A one-half interest in a single-family home in a Nevada suburb is a completely different proposition than a one-half interest in a vacation home of the same value in my Oregon resort. And this is just residential. Suppose you have a fractional interest in a strip retail shopping center, or a fractional interest in some farmland that can't be subdivided? It is possible that the strip retail could be throwing off an enormous amount of cash flow relative to its value and that on an economic basis, and under the right fact pattern, a 10% interest might be worth close to pro rata appraised value of the property. On the other hand, depending on the nature of the farmland, a 10% interest might be completely worthless on an economic basis, and it might cost more to partition the property than the potential proceeds from litigation, so the answer would be a 100% discount.

Q: What would you advise appraisers when valuing a fractional interest in real estate?

A: I don't think that the principles of valuation change much between fractional interests and any other business interests. The core question is "what does the seller have to sell?" Does the interest have control and liquidity, or not? Or something in between? What are the economic ramifications of these considerations? I think it's reasonable to assume that all sellers, whether hypothetical or real, are going to want to maximize the economic value of whatever it is they own. At the same time, the interests of the hypothetical or real buyers must also be considered. If the supply is assumed to exist (i.e., the subject interest at issue in a presumed notional or actual sale), is there demand, and if so what type of demand? Philosophically, appraisal is an exercise in estimating the point where supply and demand balance. In order to make this estimation, isn't it necessary to try to step into the minds of real buyers, real sellers, and real investors in the real world? Would a real investor use restricted stock data or publicly syndicated limited partnerships as a means to derive a lack of marketability or lack of liquidity discount and then use that information to figure out a price they would be willing to pay for a fractional interest in real estate? Of course not! It never happens.

Obviously, a fractional owner in real estate usually has the right to partition unless this right is contractually limited. When sellers of fractional interests go to market do they use the partition argument as a basis for demanding a high price? I don't think so. In fact, even at a deeply discounted price it has to be extremely rare that anyone purchases a fractional interest in real estate with the express intention of initiating a partition. The ability to partition is a last resort in case things don't work out. At the same time, this approach must be analyzed and may play a prominent role in the conclusion because this certainly is a power of the owner and partition does serve as a fallback position.

Finally, I would just say that as overarching principles when valuing a partial interest, think deeply about what it is the seller actually has to sell—what are the rights and restrictions on ownership. Analyze the options for liquidity and think about how the seller of the interest might try to maximize value in a sale. Think about the relevant potential investor pool for the interest and how the market would respond. Look at the interest from every perspective and put away the cookie-cutter. Stay as close to the real world as possible and avoid getting sucked into a lot of theoretical nonsense. Do your research instead of making assumptions, and for Pete's sake don't rely on court cases as evidence!

Eric Nath *is president of Eric Nath & Associates LLC in San Francisco. In addition to valuing fractional interests in real estate, he appraises all types of businesses and business interests for a wide range of purposes.*