MARKET DISCOUNTS FOR UNDIVIDED MINORITY INTERESTS IN REAL ESTATE

Sales of minority interests in real estate are associated with significant discounts.

by Peter J. Patchin, CRE

The fair market value of an undivided minority interest in a parcel of real estate has long been a topic of discussion among real estate appraisers. The major problem encountered in the valuation of a minority interest is an extreme lack of market data upon which to base a value judgment. While undivided minority interests in real estate are not all that rare, the sale of these interests by themselves or separate from the sale of the entire property is comparatively rare.

Publications concerning minority interest valuations have dealt with business enterprises.[1] However, data derived from a study of business enterprises is difficult, if not impossible, to apply to real estate because the rights of individuals with minority real estate interests differ significantly from the rights of minority stockholders in a corporation. One major difference is that the owner of a minority real estate interest may sue for partition of the property by a court. Under this action, all co-tenants are parties to the lawsuit either as plaintiffs or defendants. If the court finds that the property cannot be divided fairly and equitably, it orders the entire property to be sold.

Another major difference is that the co-tenant, or minority real estate interest owner, has the right to sell his interest, by itself. However, such a transaction is often difficult because the following factors detract from the quality of a fractional real estate interest as an investment. Key investment criteria of marketability, liquidity, acceptability as collateral and denomination all are affected:

- The owner of a minority interest in real estate usually has little control over the management of the property.
- Few buyers are willing to purchase fractional interest in a property.
- It is unlikely that mortgage financing can be obtained for the purchase of a fractional interest in property.
- The use of a fractional interest in real estate as collateral to obtain borrowings for other needs also is limited.
- If an owner of a fractional interest exercises his right to enforce a partition sale, substantial legal costs will result. If anticipated, a prospective buyer would deduct these costs from any purchase offer.

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- An owner of a fractional interest may have to wait until the owner of the majority interest sells out in order to avoid partition expenses and realize any capital gain.

When one reviews the difficulties involved in selling a minority interest, a discount from the proportionate value of the whole appears to be reasonable.

In an effort to gather data on market discounts in sales of minority real estate interests, an advertisement was placed in the "Data Search" column of *The Appraiser,* the monthly newsletter published by the American Institute of Real Estate Appraisers. The response to this ad was gratifying in that four MAIs provided data and valuation techniques. This information was used to analyze the results of 54 sales of minority interests in real estate, including 29 sales of minority interests in apartment buildings in Minnesota, 24 sales of minority interests in agricultural lands in Texas and other states, and one sale in a mobile home park in California. Given the wide range of property types and geographical locations, the final results were remarkably uniform.

Table 1 illustrates the differences in the sales of the minority interests by type of property and ownership. Data from 54 sales of minority interests in real estate that were sold by themselves, not as a part of a sale of the full parcel of property, indicate that the sales were associated with substantial discounts. A 35 percent discount appears to be the starting point, with adjustments up or down depending upon individual circumstances. The 29 sales of apartment building limited partnerships have a very large standard deviation, which indicates that the market was disorganized and poorly informed. The agricultural land sales studied have much smaller standard deviations, which indicates that the market was better organized and informed.

The sales of these minority interests involved far more appraisal work than normally would be associated with the same number of other types of sales. Each minority sale first had to be appraised to determine the full value of the property as a whole. Therefore, each minority sale had to be accompanied by from three to six sales of similar properties to derive the value of the whole interest.

Once the valuation of the whole interest was obtained, various techniques were employed for estimating the discount in each minority sale. Depending upon the type of property involved, estimation of minority interest discounts in land sales may be comparatively simple (see Example 1). Estimation of the discount in a sale of improved property may be difficult because of details concerning improvements made on the property and partnership rights (see Example 2).

Example 1

An undivided 1/8 interest in a 240-acre parcel of agricultural land was sold, for $21,000 in cash, in an arm's-length transaction in May 1986. Four sales of nearby agricultural lands of similar size and with similar production capabilities indicated that the market for the full interest in the parcel was $1,100 per acre. The minority interest discount for this sale was calculated as follows:

Value of Full Interest (240 Acres @ $1,100)	$264,000
Indicated Value of 1/8 Interest ($240,000 × .125)	$ 33,000
Actual Selling Price	$ 21,000
Indicated Discount $\left(\frac{\$33,000 - \$21,000}{\$33,000}\right)$	36.6%

TABLE 1

Summary Results Of 54 Sales Of Minority Interests In Real Estate

Appraiser or Data Source	Property Type	Location	Number of Sales	Size of Interest	Date of Sale	Indicated Discounts: Range	Mean	Median	Standard Deviation
Peter J. Patchin, MAI Burnsville, Minnesota	Apartment buildings Limited partnership	Minnesota	29	1.5% to 18%	1980 to 1986	0% to 82.4%	44.6%	39.7%	23.2%
Dee McElroy, MAI Wharton, Texas	Agricultural lands	Texas	6	10% to 50%	1972 to 1981	44% to 79.0%	56.0%	50.0%	11.2%
James Brabant, MAI Escondido, California	Mobile home park Limited partnership	California	1	14.3%	1985	14.6%	14.6%	14.6%	N/A
Don Harris, MAI Lubbock, Texas	Agricultural lands	Various	18	10% to 75%	N/A	15.2% to 54.5%	32.1%	N/A	8.3%
			54			0% to 82%	36.8%*	34.8%	

*The mean, when weighted by the number of occurrences in each group, is 41.2%.

Example 2

A 4.5 percent interest in a subsidized 320-unit apartment building in good condition, built in 1969 in Minneapolis, Minnesota, was sold in July 1986. Under the terms of the subsidized housing financial arrangements, the partners in the building had the right to withdraw 6 percent of their original equity capital each year as a dividend. In this case, the partner with 4.5 percent minority ownership realized annual dividends of $1,277.28. In addition, each partner had the right to participate in the capital gain obtained from the sale of the property when the subsidized housing restrictions expired in April 1988.

Analysis of comparable sales and rental data indicated that the apartment building had an unencumbered value of $9,100,000 at the time of sale of the minority interest. Assuming 3 percent per year appreciation between July 1986 and April 1988, the anticipated date of the sale of the full interest, the unencumbered value of the building would be about $9,600,000.

The value of the discount for this partnership interest could be summarized as follows:

Present Worth of Net Income ($1,277.28/year for 1 year, 10 months @ 15% equity yield discount)		$ 1,895
Present Worth of Reversion		
Selling Price of Property	$ 9,600,000	
Less: Selling Costs	$ (291,000)	
Less: Mortgages & Other Debt	$(3,197,000)	
Net Proceeds to Equity	$ 6,112,000	
Present Worth Factor to Date of Reversion @ 15%	× .8197	
Present Worth of Equity Reversion	$ 5,010,000	
Partnership Share @ 4.5%	× .045	
	$ 225,450	
Indicated Market Value of Minority Interest ($1,895 + $227,345)		$227,345
Actual Selling Price		$ 50,000[2]
Indicated Discount $\left(\frac{\$227,345 - \$50,000}{\$227,345}\right)$		78.0%

An attempt was made to learn if the minority interest discount varied with the size of the minority interest. Since the cost of a partition action would be the same regardless of whether a fractional interest was 5 percent or 50 percent, one would expect the smaller fractional interest to bear larger discounts. After the results of the sales were arrayed in order by the size of the minority interest, no consistent pattern was found between the size of the discount and the size of the minority interest. Therefore, this particular data group yields no evidence that smaller minority interests bear larger discounts.

Conclusions

There is considerable published evidence to support the concept of using discounts in the sale of minority interests in real estate. For instance, a recent *Wall Street Journal* article stated that major secondary market buyers of limited partnerships "demand a 20 percent to 40 percent discount from asset value."[3] In addition, the principle of minority discounts has long been a part of case law. A recent court decision reaffirmed the principle, by allowing a 15 percent discount for 50 percent ownership interest.[4] The results of the foregoing study consequently do not stand alone.

Although the study identified a 35 percent mean/median discount in 54 sales of minority real estate interests, the discount most likely will vary depending on the relationship among owners and the likelihood of sale of the full property. If a property is likely to be sold as a whole in the foreseeable future and the various owners are in harmony, the discount may be lower than the 35 percent mean/median discount. On the other hand, if there is discord among the owners and no prospect of selling the whole property in the foreseeable future, the discount may be much larger.

NOTES

1. Harper, John S., Jr. and Lindquist, J. Peter. "Quantitative support for large minority discounts in closely held corporations," *The Appraisal Journal*, April 1983, p. 270.
2. The actual selling price may be compared to the original investment of approximately $21,000, some 17 years earlier. This apparent capital gain, plus tax advantages derived over the life of the investment, helps explain the seller's motives.
3. Braunigan, Martha and Lipman, Joanne. "Getting out: A secondary market emerges for limited partnerships," *The Wall Street Journal*, May 1, 1986, sec. 3, p. 1.
4. *Propstra v. U.S.* 680 F 2d 1248 (U.S.C.A., 9th Cir, 1981).