

## Private Property Vehicles: The Valuation of Interests in Limited Partnerships

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## **Abstract**

*This paper examines the extent to which the valuation of partial interests in private property vehicles should be closely aligned to the valuation of the underlying assets. A sample of vehicle managers and investors replied to a questionnaire on the qualities of private property vehicles relative to direct property investment. Applying the Analytic Hierarchy Process (AHP) technique the relative importance of the various advantages and disadvantages of investment in private property vehicles relative to acquisition of the underlying assets are assessed. The results suggest that the main drivers of the growth of the this sector have been the ability for certain categories of investor to acquire interests in assets that are normally inaccessible due to the amount of specific risk. Additionally, investors have been attracted by the ability to 'outsource' asset management in a manner that minimises perceived agency problems. It is concluded that deviations from NAV should be expected given that investment in private property vehicles differs from investment in the underlying assets in terms of liquidity, management structures, lot size, financial structure inter alia. However, reliably appraising the pricing implications of these variations is likely to be extremely difficult due to the lack of secondary market trading and vehicle heterogeneity.*

## **Introduction**

The growth of private indirect property vehicles has been one of most dramatic changes in the property investment market over the last decade. Most notably, there has been a major increase in the use of Limited Partnership structures. However, the product universe is diverse, with all structures having at their core the 'wrapping' of the property assets into a multi-investor vehicle. Whilst, the appraisal of the underlying assets is typically carried out by the 'normal' property valuation sector, a new breed of property professional has emerged to deal with investment in (and the valuation of) interests in private property vehicles. This sector of the market has developed rapidly and, consequently, market participants are seeking more sophisticated methods to price products as well as finding explanations for the pricing observed in the market place.

The aim of this paper is to examine the extent to which the valuation of interests in private property vehicles should be closely aligned to the valuation of the underlying assets. The valuation of fractional or partial interests has generated a range of research ranging from shared ownership of a single asset to the problems of property company valuation. Given that investment in private vehicles provides a range of additional advantages and disadvantages relative to direct ownership, we expect that there should be some deviation from a simple asset driven approach. In this paper we build on Newell and Fife (2002) and apply an Analytic Hierarchy Process (AHP) technique to assess the relative importance of the various advantages and disadvantages of investment in private vehicles.

### **Forms of indirect property investment**

One, often overlooked feature, of the indirect property market is the sheer diversity of vehicles. Indirect property investment in the UK is generally undertaken through employing one of three legal formats: partnerships, unit trusts or companies. Broadly speaking, these formats can be seen as lying on a continuum in terms of size, trading volume, number of investors and regulatory framework ( see Figure 1 for a schematic representation) .

Figure 1

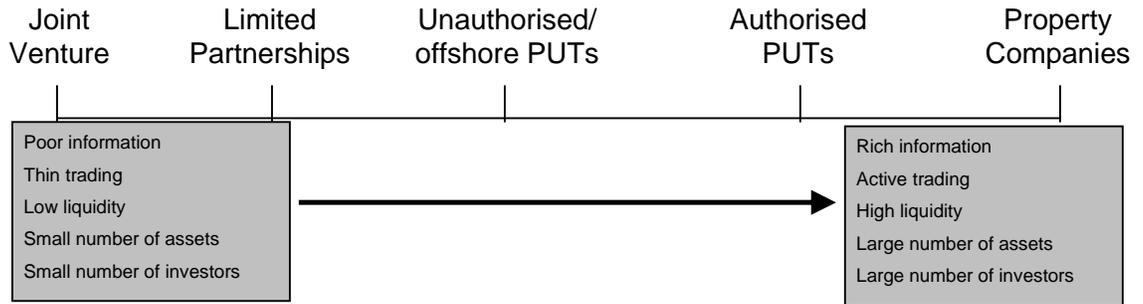


Figure 1 shows that the vehicles can range from joint ventures - vehicles with two or three investors pooling money and know-how for a certain time span (implying virtually no trades) and a clearly defined (typically small) asset base - towards property companies listed on the stock exchange with a high number of investors and a large portfolio of assets (in value and number). While joint ventures are normally tailored towards the particular investor needs, property companies are governed by regulations to decrease investor risk, which leave little room to accommodate individual investor needs.

In the following section, the Limited Partnerships, Property Unit Trusts and property company structures as well as their degree of utilisation in the UK market are discussed. Furthermore, recent changes in the investment environment and their implications for the indirect market will be identified.

### *Private Property Vehicles*

Limited Partnerships have been one of the most commonly employed vehicle structures to pool property investment. Based on the Limited Partnership Act 1907 these structures need a minimum of two partners; a general partner, in charge of management and fully liable for the partnerships assets/debts, and a limited partner, whose liability is by contrast limited to his share of capital invested. This limited liability status is conditional on the non-involvement of the limited partner in management decisions.

Another typical structure used for pooled investment in a portfolio of assets is unit trusts, with Property Unit Trusts (PUTs) investing in the property sector. PUTs are based on trust law which means investors typically elect a supervisory board, acting in a representative function for the investors in appointing and supervising the trustee and the investment manager. The trustee is responsible for the operation of the trust while the investment manager deals with the investment decisions and issuance and redemption of fund units.

In order for a PUT to be advertised and sold to retail investors the PUT needs to be authorized according to the Trustee Investment Act 1961; all other funds are therefore unauthorised. The authorisation by the FSA implies certain restrictions on portfolio choice, redemption and cash-holding, which have been lightened considerably by the new collective investment scheme sourcebook, COLL, which came into force in 2004 (Lizieri & Ward, 2004).

UK based unauthorised PUTs tend to be exempt structures implying that they are only open to tax exempt UK investors, which makes them tax transparent like LPs. These PUTs are often employed by small and medium sized institutional investors to gain exposure to quasi-diversified portfolios of commercial property assets. The issuance and redemption of PUTs units close to net asset value (NAV) and limited trading in the secondary market make the risk-return profile of PUTs close to reported appraisal based market performance indices. In addition to the UK based or onshore PUTs institutional investors are currently seeking exposure to offshore PUTs in tax havens like Jersey and Guernsey.

One of the longest running forms of indirect property investment vehicle is a listed property company. However, listed property companies have not participated on the upwards trend in indirect property investment during the last decade. Three reasons are responsible for this development. Listed companies are not tax transparent, implying that they are taxed twice first on the company level then on the investor level. In comparison to direct or other indirect formats they are therefore tax inefficient structures. Secondly listed property companies show a closer correlation to the equities market than to the property markets making them less attractive for institutional investors seeking a different way to gain property exposure. The strongest driver, however, seems to be the discount to NAV most property

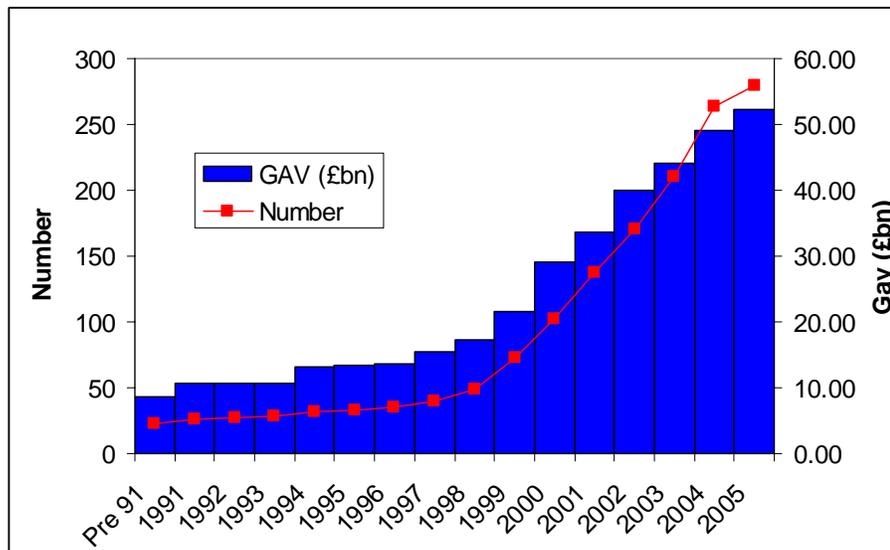
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<sup>3</sup> The strong growth of fractional interest is not only common in the UK but for example also in the US and Australia see Hess and Liang (2004) and Newell/ Keng/ Fife (2005).

companies are traded at (Kutsch & Lizieri, 2005). Barkham & Ward (1999) showed that the discount has widened sharply during the late 1990's, which led to several companies being taken private and therefore decreasing market capitalisation. They estimated that the long-run discount is 25% of NAV.

Figure 2 shows the development of UK private indirect market over the last 15 years. The majority of the gross asset value (GAV) is invested in PUTs onshore and offshore as well as LPs, but does include less popular structures like managed funds and private companies.

Figure 2: Market Growth in the Indirect Property Market in the UK



Source: OPC, March 2005

Looking at Figure 2 it is obvious that the private indirect market experienced exponential-type growth since 1999/2000<sup>3</sup>. This growth has been mostly driven by Limited Partnerships, which have been the vehicle of choice for a number of years. Illustrative of the sector's propensity to sudden shifts in vehicle structures are the implications of two recent events that triggered dramatic changes of the market structure.

Firstly, the introduction of Stamp Duty Land Tax (SDLT) increased transaction costs of secondary trading dramatically. The changes in property transaction taxation introduced a 4% tax liability on the *gross asset value* of the partnership for the transfer of limited partnerships interest. Due to the fact that many LPs have loan-to-

value ratios of about 60% this implies transaction costs of about 10% for the equity interest. The second change in the investment environment reducing the popularity of limited partnerships has been the introduction of the Jersey expert fund regime by the Jersey Financial Service Commission (JFSC). The expert fund regime eases the establishment of new funds that meet the conditions of exceeding an asset value £52,000 and have a minimum of two board members who are Jersey residents. Both events occurring in close proximity have started a wave of LPs being moved offshore into Jersey Property Unit Trusts (JPUTs), which are not affected by the taxation changes.

Even though the market has grown considerably, research concerning private property vehicles (PPVs) is limited. Oxford Property Consultants (2001) has in cooperation with the University of Reading undertaken research in this field seeking the views of investors, managers and advisors within the market.<sup>4</sup> Baum (2001) found that this structure is attractive to institutional investors due to their unregulated status and high level of flexibility to meet investor needs. In addition, tax transparency and the ability to gear (circumventing restrictions investors might be subject to in direct investment) seem to be positive characteristics of the structure. Other key advantages of PPVs cited were access to management expertise and access to projects that usually exceed the capital constraints of the investors. Further the alignment of interests with the manager<sup>5</sup>, the transparency of information and the possibility to access gearing<sup>6</sup> were mentioned as being advantageous in comparison to direct investments.

On the other hand a major concern raised by the participants was the lack of liquidity, which might cause particular difficulties in a market downturn. Connected with this issue is the lack of an established secondary market and the uncertainty about market prices. The valuation technique identified is a simple apportionment of the vehicles net asset value. A shortcoming of this survey is that it simply listed the main advantages and disadvantages of the private vehicle investment route and does not gauge the relative balance between or the relative importance of the reported costs and benefits.

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<sup>4</sup> The research report generally identifies the views of the three groups: advisors, investors and managers separately and then identifies market consensus. The review here given will focus on these consensus statements. Readers how are interested in the opinions of single groups should refer directly to the report.

<sup>5</sup> Which can be achieved through either co-investment or performance related remuneration.

<sup>6</sup> This is mainly the case for pension funds which are often restricted in the trustee treaty to use gearing in their direct property portfolio.

The doubts associated with the approach to valuation are not only a UK phenomenon. Fife and Newell (1995, 2002) showed that internationally approaches have been inadequate through insufficient detailed analysis and unreliable comparable information. The body of knowledge in fractional interests is limited and often anecdotal, with much of the evidence using property security data as comparables (Fife and Newell, 2002; Wiggins and Rosenberg, 2001). Specific aspects considered in the valuation of fractional interests have included:

- directional control of asset (Healy, 1988)
- relative liquidity of fractional interests compared to whole (Hall, 1989)
- compatibility of co-owners (Donaldson, 1994; Stewart, 1997)
- transfer constraints of present co-ownership structure (Donaldson, 1994)
- discounting methodologies for lack of control and lack of marketability (Webb, 2001; Wiggins and Rosenberg, 2001)
- risk factors (Thompson and Dagbjartsson, 1994; Webb 2001)
- impact of number of co-owners on discount (Humphrey and Humphrey, 1997).

This lack of established procedures to assess the value of fractional interests confirms the valuation issues as being inadequately understood (Fife and Newell, 2002); hence reinforcing the risk from such fractional interest investments in Limited Partnerships.

Many studies refer to comparables from the listed indirect market, like REITs or property companies, or samples of actual trading of limited partnership interests. As aforementioned the public and the private indirect market have shown differences in their development over the last decade. Whilst market participants report premiums to NAV in the private indirect market, property companies trade at a long-term discount to NAV of 25% as observed by Barkham & Ward (1999). They concluded in their research that many indicators show that the discount can be traced back to noise trader<sup>7</sup> in the market. Noise traders in the equities market are retail investors however collective investment limited partnerships are (normally) exclusive for institutional investors. A transfer of the results therefore seems to provide limited

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<sup>7</sup> Noise traders are irrational traders that create noise in the market and are a potential risk to rational traders. The rational investor will price this risk into their prices.

insights. Trying to find answers by actual trade data is problematic since there is no established secondary market or market-maker who could generate data. The lack of data is increased further by a generally low number of trades taking place with most being undertaken by means of a private treaty and under confidentiality.

Newell and Fife (2002) carried out research in Australia aiming to maintain some inside in the drivers of valuations of fractional interests in Australian LPTs. They identified and prioritised 22 key factors, five factors with 17 sub-factors, by employing the Analytic Hierarchy Process (AHP). 15 owners and 18 valuers responded. They judged that the underlying asset quality had the highest importance with 34.5%, followed by control and the terms of the co-ownership agreement with approximately 18% each and ownership structure and liquidity with approximately 14% of importance each in determining the value of a fractional interest. The relatively low ranking of liquidity and control came as a surprise considering their predominance in literature. A further investigation of the results split into owner and valuer groups showed no significant differences in the assessment of a fractional interest. The highest influence on the value had the sub-factor level were given to voting inequality, revenue inequality and ownership costs<sup>8</sup>.

In summary, the central issue is that by investing through private collective vehicles rather than through direct acquisition of the property assets themselves, investors are investing in assets with different investment qualities than ownership of the underlying assets. Relative to direct ownership, there are significant differences in liquidity, trading and price formation, search costs, management control, lot size, taxation and transaction costs inter alia. A priori, we expect these differences to have pricing implications. It would be surprising if a simple pro-rata division of NAV accurately reflected their pricing implications - even if the NAV was reliably appraised.

### **Research Methodology**

A replication of the research undertaken by Fife and Newell (2002) for the UK market was the original vantage point for this research. However, important structural differences that exist between Australian LPTs and UK limited partnerships needed be accommodated while identifying the key factors for limited partnerships.

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<sup>8</sup> This ignores underlying asset quality for which no sub-factors were identified.

Nevertheless, the theoretical basis in shape of the AHP is kept. AHP has been used extensively in property research in identifying and prioritising factors in the areas of building quality, house selection, LPT fractional interests, environment planning and housing (Ball and Srinivasan, 1994; Bender et al, 1999, 2000; Fife and Newell, 2002; Ho, 1999; Ong and Chew, 1996). Partovi and Burton (1993) described the methodology as a simple three-step process:

- i. Description of the decision problem in form of a hierarchy, through the identification of decision criteria and sub criteria.
- ii. Calculation of the relative weights of the decision criteria on each level of the hierarchy using pair-wise comparison of the criteria.
- iii. Development of a decision model through the integration of the relative importance of the criteria.

The first step was, therefore, the identification of factors and sub-factors. Those are based on previous research as well as pilot interviews with experts in the industry. A full list of the factors can be seen in Appendix 1. The factors are split into four categories:

- Benefits associated with investing in private vehicles (access to specialist management, tax efficiency, ability to gear, access to assets),
- Benefits associated with the LP structure itself (limited liability, fixed life span, interest alignment, presence of co-investors),
- Costs associated with reduced liquidity (pre-emption rights, limited secondary market, effects of limited lifespan, market price uncertainty)
- Additional costs associated with LP structure (complexity of structure, fees, gearing risk, performance measurement uncertainty, potential conflict with co-owners)

A number of the variables hypothesised can be viewed in terms of being a disadvantage or advantage. For instance, the ability to gear could be an attraction of the vehicles for investors who have gearing restrictions. At the same time, many investors view the additional risk of gearing and the implications for the pattern of

investment performance in negative terms. Similarly, the presence of co-investors provides a signal to investors that a vehicle is appropriate but produces a potential for conflict with co-investors about asset and vehicle activities.

In a second step the relative importance of the factors needed to be assessed. Respondents were asked to make pair-wise comparisons of the factors and rate them on a scale of 1-5. The scale runs from 2 “slightly more important” increasing to 5 “completely dominates”; 1 is indicating equal importance.

The final step was the analysis of the questionnaires using the Expert Choice 11 software, which calculates the relative importance as a percentage. By evaluating the factors and sub-factors a hierarchy of the sub-factors could be produced taking into consideration the relative importance of both levels.

One initial explicit aim of the research is to investigate whether these vehicles should trade at discounts or premiums to their NAV. Hence one initial aim of the research was to assess the extent to which the positive factors to direct ownership (producing a premium) would outweigh the negative factors (producing a discount). It is anticipated that the advantages will be perceived to outweigh the disadvantages considering the rapid market growth of this sector. As a result, the main contribution is expected to be an evaluation of the relative importance of the various advantages and disadvantages specified.

In terms of limitations, our survey will only provide a single snapshot of investors' perceptions. For instance, liquidity (in terms of ability to exit at market price) will vary over time and between assets. In the same way that the deviation from NAV varies over time for property companies and also varies between property companies, it is also to be expected that there will be similar patterns to deviation from NAV for private vehicles.

### *Sample*

A sample of investors was asked to undertake pair-wise comparisons and rate the relative importance of the characteristics for the second step of the AHP. The 18 interviewees all had current or prior active involvement in the indirect property investment market for limited partnerships, which means that non-investors were excluded from the sample. Data provided by Oxford Property Consultants showed

that many investors seek external investment advice from professional advisors, which were therefore included in the sample. The majority of advisors are also actively managing their own vehicles and/or actively investing their own money into indirect structures. Non-investors are difficult to identify and their exclusion from the sample suggests that it may be positively biased towards benefits of investment in private vehicles. However the sector is still in its development phase and non-investors might not necessarily have taken an active step to refuse investment in this sector. The interviews in which the participants were asked to fill in a paper based questionnaire were mainly held during the months of March, April and May in 2005.

## **Results**

The results of the comparison process are displayed in Table 1. As expected, a clear-cut finding is that respondents found that the investment benefits of limited partnerships significantly outweigh the costs associated with this approach to property investment. Considering the exponential-type growth of the market, this result was anticipated. It is unlikely that the market would have grown at the rate that it has if investors did not view the vehicles as offering significant advantages relative to direct investment. It seems reasonable to argue that if these benefits are not incorporated into the estimation of the NAV of the vehicles, then we may observe premiums to NAV<sup>9</sup> when the assets are traded.

More specifically, it is the fact that the vehicles offer investors the ability to access both particular assets and specialist management that seems to be the key attractions driving this growth. For investors excluded from sectors such as shopping centres, retail warehouse parks and 'trophy' office developments due to problems of lot size and specific risk, private vehicles offer an attractive option. Ability to gear and tax efficiency remain important in the overall context but are dominated as investment benefits by the access to specific assets at the right lot size and specialist management.

Clearly, the pricing effects of these variables will be contingent upon the perceived quality of the management and the nature of the underlying assets. Given that

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<sup>9</sup> Our discussions with market participants indicated that the calculation of NAV was usually a mechanistic process based on the estimation of Gross Asset Value and deducting the estimated value of liabilities (debt, management and other fees). There were few exceptions to this 'rule' despite the fact that most interests are currently trading at premiums to NAV.

management ability should affect expected future cash flows, it seems reasonable that investors will pay a premium to have their assets managed by high quality managers. However, in the absence of market pricing signals, appraisers will have problems quantifying this factor. Further, the 'wrapping' of the assets in vehicles creates a new price formation environment. The main effect is that there is a larger pool of potential buyers. A premium may be justified where investors are offered the benefits of access to previously 'unavailable' assets, an appropriate lot size (reduced specific risk), lower search costs and fast execution associated with Limited Partnerships. The key benefit for investors in terms of the vehicle structure was the ability to align the interests of the manager and the investor. This is typically facilitated by co-investment and performance-related fee structures. However, again in the absence of pricing signals, valuers will face problems of attaching monetary values to these effects.

A key reason for the lack of reliable pricing signals is the lack of liquidity/trading. One source of major concern in the market still is the liquidity of a limited partnership investment. After investment benefits, liquidity costs were the second most important group of factors. Within this group, lack of secondary market trading was the most important aspect of lack of liquidity. Although participants often argued that the current market allows for fast execution of fractional interest sales, they questioned the marketability of such interests in a market downturn. This implies that investors are aware that liquidity is closely linked to market conditions. Revealingly, a central London residential fund was mentioned as being currently relatively illiquid and was being valued at a discount to NAV. As suggested earlier, liquidity (ability to exit at fair value) varies cross-sectionally between various interests and structures and will change at an aggregate level over time.

**Table 1: Relative importance of valuation criterias**

<b>Factor</b>	<b>Weight</b>	<b>Subfactor</b>	<b>Weight</b>
Investment benefit	47.82%	Access to specific asset	30.08%
		Access to specialist management	29.71%
		Tax efficiency	22.09%
		Ability to gear	18.14%
Liquidity Costs	19.77%	Limited secondary market trading	38.67%
		Liquidity effects of limited life span	22.24%
		Market price uncertainty	21.39%
		Pre-emption rights	17.69%
Positive aspects of LP structure	17.86%	Interest alignment with manager	38.76%
		Limited Liability	28.95%
		Presence of co-investor	22.41%
		Fixed life span	9.88%
Other costs of LP structure	14.54%	Management fees	34.52%
		Risk through gearing	24.58%
		Potential for conflict	19.23%
		Performance uncertainty	11.26%
		Complexity of LP Structure	10.41%
Total	100%		

Compared to liquidity-related issues the other costs associated with the LP structure were regarded as less important. In the interviews, management fees were often raised by market participants are a source of friction between managers and investors. However, whilst they may be a justifiable source of concern to investors, such fees do not seem to raise problems for appraisers. Although there is scope for variations in accounting interpretation, fee liabilities can be quantified and incorporated into the appraisal process.

Interestingly, the ability of high gearing to change the performance patterns of the investment was regarded the next important problem of the vehicles. The gearing point reflects some of the difficulties inherent in this research. Discussions suggested that the attractiveness of various gearing levels varied with investor. In essence there were significant clientele effects and it is extremely difficult to make a general judgement about whether the ability to gear is an advantage or disadvantage. Additionally, the perception of gearing is also linked to the amount of gearing.

Table 2 sets out the overall hierarchy of factors. These are simply calculated by multiplying the weight of the main category by the weight of the sub-factor within that category. Clearly, given the strong dominance of 'investment benefits' the four sub-factors in this category are at the top of the rankings. The only disadvantages of the vehicles that have any prominence are the management fees and lack of secondary market trading.

**Table 2: Hierarchy of sub factors**

<b>Ranking</b>	<b>Sub factor</b>	<b>Weight</b>
1	Access to specific asset	14.52%
2	Access to specialist management	14.48%
3	Tax efficiency	10.39%
4	Ability to gear	8.44%
5	Limited secondary market trading	6.26%
6	Interest alignment with manager	6.09%
7	Management fees	5.55%
8	Limited Liability	5.31%
9	Liquidity effects of limited life span	4.98%
10	Presence of co-investor	4.71%
11	Market price uncertainty	4.36%
12	Pre-emption rights	4.17%
13	Risk through gearing	3.27%
14	Potential for conflict	2.56%
15	Fixed life span	1.75%
16	Complexity of LP Structure	1.59%
17	Performance uncertainty	1.57%
Total		100%

## **Conclusion**

The rapid growth of investment in private property vehicles has led to the emergence of a new breed of property professional who specialise in their creation, management, transfer and appraisal. Although the vehicles are diverse, they have in common the creation of partial interests in returns linked directly to the underlying property assets. However, investment in the private property vehicles differs from investment in the underlying assets in terms of liquidity, management structures, lot size, financial structure inter alia. This leads to the first important conclusion that deviations from NAV should be expected. Additionally, just as importantly, there are significant differences in liquidity etc among the vehicles. Therefore, there will also be significant variations in the extent of deviations from NAV among the vehicles. Both issues add complexity to the process of estimating the exchange price of partial interests in private property vehicles.

The main contribution of this research is that it improves our understanding of the key drivers of the growth of this increasingly important sector of the property market. The main drivers have been the ability for certain categories of investor to acquire interests in assets that are inaccessible due to the amount of specific risk. Additionally, investors have been attracted by the ability to 'outsource' asset management in a manner that minimises perceived agency problems. Since the financial impacts of the variables discussed are contingent upon both the characteristics of the specific vehicle and prevailing market conditions, the research is probably of little practical use to the appraisers of interests in vehicles. Reliably incorporating these time and asset-specific variables into appraisals is likely to require an active secondary market in similar interests to provide reliable market signals of their pricing effects.

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### Investment benefits of LP

- **Access to specialist management** – The vehicle is managed by specialist in the sector.
- **Tax efficiency** – Assuming an offshore vehicle is typical, Stamp Duty is avoided.
- **Ability to gear** – Investor is able to access geared property investment.
- **Ability to access specific asset at appropriate lot size** - Investor is able to purchase interest in large assets. Direct acquisition would not normally be feasible due to the high level of specific risk.

### Positive aspects of LP structure

- **Limited liability** – The investor's liability is limited to the amount s/he has paid in.
- **Fixed life span** – There is a definite exit point for the investor.
- **Interest alignment with manager** – There is alignment of interest through co-investment by the manager of the vehicle and performance related fee structure.
- **Presence of co-investors** – Provides signal that the vehicle is appropriate.

### Liquidity costs

- **Pre-emption rights (if present)** – Investor's disposal options are limited.
- **Limited secondary market** - Limited active secondary trading in LP interests can increase the uncertainty in timing and amount of capital receipts.
- **Liquidity effects of limited lifespan** – As the vehicle approaches a potential wind-up point, consequent uncertainty in future investment horizon limits marketability of interest.
- **Market price uncertainty** – Difficulties of valuation relative to direct investment can produce valuation uncertainty associated with LP interest and affect the sale process.

### Other costs of LP structure

- **Complexity of LP structure** – Investor faces additional costs due to complexity of scheme. At purchase there are additional due diligence costs. During the holding period, the investor must monitor and manage the vehicle.
- **Higher management costs and performance related fees** - Management costs and fees for a LP interest are higher relative to direct holding.
- **Risk through gearing** - Investor is exposed to additional financial risk due to gearing.
- **Performance measurement uncertainty** - Uncertainty of performance measurement in LP scheme due to additional valuation uncertainty.
- **Potential conflict with co-owners**- Possibly that there will be potential disagreement among co-owners about asset and vehicle activities