



HOW TO VALUE PRIVATELY HELD PROMISSORY NOTES

By Bruce A. Johnson, ASA

Promissory notes are commonly used for the transfer of wealth between family members or their legal entities, like trusts, limited partnerships and corporations. Sometimes, these notes are issued to make a loan to a son or daughter to buy real estate or to fund a business start-up.

However, many of these notes originate from the sale of company stock or limited partnership interests to a younger generation. This sometimes occurs when the parents want to transfer ownership of their business, but also want to replace dividend income from the business with interest income from a note.

Another type of transaction using notes occurs when the parents have used up their one-time exclusion amount, but still have additional ownership in their business to transfer. This transfer can be accomplished by a sale from the parents to their children who issue a note in return. In other instances, siblings or trusts may desire to transfer assets between entities and notes are used in these transactions.

If the transaction is a gift or the note becomes an asset in an estate, the note must be valued at fair market value (FMV). We know that the IRS definition for FMV, as stated in Revenue Ruling 59-60, is:

... the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts.

With regard to FMV, it is important to note:

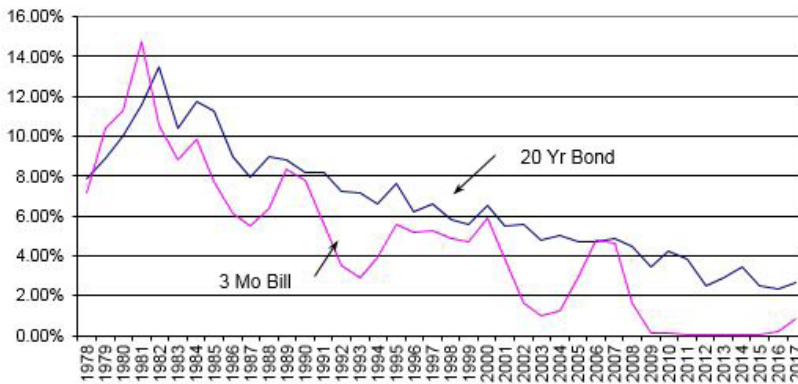
In most interpretations of fair market value, the willing buyer and willing seller are hypothetical persons dealing at arm's length rather than any "particular" buyer or seller. In other words, a price would not be considered representative of fair market value if influenced by special motivations not characteristic of a typical buyer or seller.¹

When it comes to valuing a note, the key factors that impact the value are the stated interest rate and the amortization schedule of the note. A note with a below market interest rate would sell at a discount from its balance just like bonds trade in the public market. Therefore, a buyer would want to purchase a note at a discount from the balance to increase the interest rate of the note to a market rate. When examining the amortization of the note, notes that are interest only or

that don't mature for 30 years are more risky than short-term notes, because the buyer will not receive his/her return of principal for a long time.

Just like a publicly traded bond, investors require a higher rate of return for a long-term note, because they are exposed to more risk over the life of the loan. As shown in Figure 1, rates on long-term bonds are typically higher than those of short-term bonds, since an investor is exposed to more risk over longer periods of time and, therefore, requires a higher rate of return. The same holds true for privately held promissory notes.

Figure 1. Long-Term vs. Short-Term Bonds



Other factors like collateral, payment history, marketability and the note covenants are also important to determining the value.

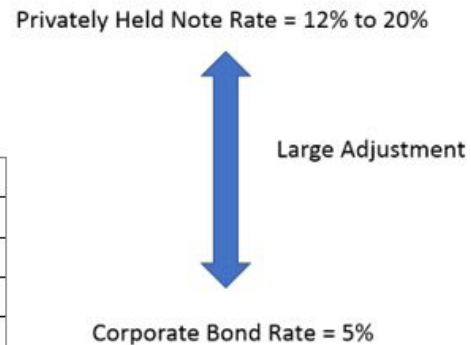
Market Rate of Interest

As one example, if the initial interest rate for a note is low compared to market rates, and the note is small and has poor collateral or a sporadic payment history, the FMV of this privately held promissory note is typically less than its outstanding balance (i.e., a buyer would discount the current balance of the note to increase its rate of return to offset the risk of the note). Therefore, a primary component of calculating the FMV of a note is to determine an appropriate market rate of interest.

At a minimum, the IRS stipulates that an interest rate called the Applicable Federal Rate (AFR) be used for loans between related parties. However, these rates are typically low compared to a market interest rate for a privately held investment. For example, the AFR ranged from 2.7% for a short-term note to 4.3% for a long-term note as of the date of this article. These rates approximate the Moody's AAA rates for corporate bonds, which is the highest bond rating and is awarded to the safest bonds of large publicly held companies.

In real world transactions, interest rates for small privately held notes typically range from 12% to 20%. (See Figure 2.) This large gap requires appraisers to make large adjustments if they use corporate bond interest rates as their basis when valuing privately held notes. Many times, this adjustment can be two or three times the original corporate bond rate.

Figure 2. Rates



As can be surmised, for privately held notes that are not comparable to corporate bonds, the large adjustments represent too large of a leap of faith to objectively value a privately held note. Considering the disparity between the AFR and real-world rates, appraisers should attempt to identify

the most appropriate guideline data that is comparable to privately held promissory notes to determine an appropriate market rate of interest.

Corporate Rates Generally Not Applicable

In the past, appraisers used corporate bond rates to value privately held notes, because no other information was thought to be available. A constructive comparison to express this point might be to look at how business appraisers value operating companies. If a privately held company is large enough, appraisers use pricing multiples (i.e., P/E Ratio) to value a privately held company by comparing publicly traded companies to the subject privately held company.

However, if the private company is small and not geographically diversified, the use of the market approach is not applicable, because publicly traded companies are too big and diversified, even though they are in the same line of business. For example, it would be incorrect to use Home Depot or Lowes to value the stock of a local hardware store. This analogy is true for small privately held notes. These types of notes are not like corporate bonds issued by Home Depot, GE and Dow Chemical that have interest rates between 5% to 8%. A third-party buyer of a privately held note would require an interest rate of

12% to 20% to reflect the true risk of the investment. The following discussion represents a method for determining and applying an appropriate market rate in the valuation of a privately held promissory note.

Mechanics of the Valuation

The task of a business appraiser when valuing a privately held note is twofold. First, they must determine a market rate of interest based on the risk of the note and, second, they must calculate the present value of the future principal and interest payments of the note using its expected amortization.

Let's look at an example of a privately held note exchanged between family members for the purchase of a limited partnership interest with an initial balance of \$400,000 at an interest rate of 3% for a term of five years. The terms are:

Original Balance = \$400,000
 Interest Rate = 3%
 Term = 5 years until maturity
 Annual P&I Payment = \$87,342
 Valuation Date = January 1, 2019

The loan is not personally guaranteed, but is collateralized by the limited partnership interest that was purchased. The schedule in Figure 3 reflects the amortization of the loan.

Figure 3. Amortization of Loan

Original Balance \$400,000
 Interest Rate 3.0%

	Year 1	Year 2	Year 3	Year 4	Year 5
Beginning Balance	\$400,000	\$324,658	\$247,056	\$167,126	\$84,798
P&I	\$87,342	\$87,342	\$87,342	\$87,342	\$87,342
Interest	\$12,000	\$9,740	\$7,412	\$5,014	\$2,544
Principal	\$75,342	\$77,602	\$79,930	\$82,328	\$84,798
Ending Balance	\$324,658	\$247,056	\$167,126	\$84,798	\$0

The first step is to determine a market rate of interest, which consists of two components – an appropriate base rate and a specific risk premium based on an analysis of the risk of the promissory note, which includes evaluating horizon risk, payment history, amortization structure, default provisions, personal guarantees, collateral and marketability. When added together, these two components derive a market rate of interest for a note.

Since a hypothetical buyer has many alternative investment choices, it is important to base any rate of return analysis on measurable alternative investments with comparable levels of risk. Instead of using corporate bonds, a better comparison is to examine the yields of

publicly traded Business Development Companies (BDCs) as an alternative investment. BDCs are typically formed as closed-end registered investment companies and provide financing to small and medium-sized privately held businesses.

The assets of BDCs are primarily comprised of a diversified portfolio of senior secured, second lien and mezzanine debt from privately held entities. Selected BDCs specialize in a specific industry, but the larger funds represent a well-diversified portfolio of debt securities.

BDCs were created by Congress in 1980 to encourage the flow of public capital to small and medium-sized private businesses in the United States. Typically, BDCs lend to small and medium-sized private companies that carry a rating of BBB- by Standard and Poor's. There are multiple shareholder protections and government compliance regulations that a BDC must meet. BDCs:

- are exempt from corporate income taxes as long as they pay out at least 90% of their taxable income back to shareholders in the form of dividends.
- are required to file quarterly and annual reports with the SEC and have restrictions on the amount of debt they can hold.
- cannot invest more than 25% of the value of their assets in the securities of one issuer.
- must comply with the Sarbanes-Oxley Act, the Dodd-Frank Act and the Investment Company Act of 1940.
- must place their securities in the custody of a bank or be subject to an additional audit and certain operational procedures to protect investors.
 - must maintain a bond from an insurance company to protect shareholders from fraud or embezzlement.

There are both publicly traded and non-traded BDCs. As of the date of this article, approximately 45 BDCs were actively traded in the public market. Their current market yields ranged from a low of 7% to as much as 16%. The internal lending rates for collateralized loans of publicly traded BDCs typically range from 9% for larger

companies to 15% for smaller companies. The lending rates of non-traded BDCs can be as high as 20% for short-term loans with personal guarantees.

Publicly held BDCs are listed on either the NASDAQ or NYSE, must comply with the corporate governance standards of the exchanges and are subject to regulatory exams by the SEC.

The current market yield of BDCs, or their internal lending rates, can be used as a starting point (base rate). For purposes of determining an appropriate market rate of interest for our example of a privately held note, the current market yield of the five largest publicly traded

BDCs was used to determine a base rate. The five largest BDCs and their current yield are shown in Figure 4. As reflected, the average annual yield was 10.4%.

Figure 4. BDC Chart

<u>5 Largest BDCs</u>	<u>Ticker</u>	in millions		1/1/2019	Annual	<u>Yield</u>
		<u>NAV</u>	<u>Price</u>	<u>Dividend</u>		
Ares Capital Corp	ARCC	\$7,320	\$15.58	\$1.54		9.9%
Apollo Investment Corp	AINV	\$4,170	\$12.40	\$1.20		9.7%
Prospect Capital Corp	PSEC	\$3,430	\$6.31	\$0.72		11.4%
FS KKR Capital Corp	FSK	\$2,070	\$5.18	\$0.66		12.7%
Main Street Capital Corp	MAIN	\$1,510	\$33.81	\$2.85		<u>8.4%</u>
Average						10.4%

Next, a specific risk premium is added to the base rate to determine a market rate of interest. Specific risk premiums for financial investments usually range from 2% to 6% and compensate an investor for the additional risk factors that are not reflected in a publicly traded alternative investment.

The addition of a specific risk premium is based on the premise that as the risk of an investment increases, the required rate of interest will also increase. The following factors should be considered when determining the specific risk premium.

1. Horizon Risk – Long-term notes require higher interest rates than short-term loans, since the buyer of a long-term note would be exposed to changes in micro and macro economic factors over the holding period of the note. In our example, the five-year term was considered a long-term note, so the risk of the investment is increased.

2. Payment History – Notes with a history of on-time payments are less risky than notes with no payment history or notes that are in default. In our example, this is a new note with no payment history. Therefore, the risk is increased for this factor.

3. Amortization Structure – A note with a large balloon payment might be considered to reflect more risk, due to the uncertainty of the ability to pay the balloon payment or be refinanced. Similarly, an interest-only note or zero coupon style note is more risky than a note that makes regular interest and principal payments. In our example, the note's amortization is simple principal and interest payments. Therefore, the risk is not increased for this factor.

4. Protective Covenants – The provisions of a note should allow the holder to take legal action in the event of default

in order to take possession of the collateral. Notes without strong protective covenants would be considered more risky. In our example, the note agreement is well written and protects the note holder in case of default. Accordingly, the risk was not increased for this factor.

5. Collateral – Notes that are sufficiently collateralized by real estate or other tangible assets are less risky than uncollateralized notes. An uncollateralized privately held note would be difficult to sell to a third party. In our example, the note is collateralized by a limited partnership interest. This issue requires an analysis of whether the limited partnership interest sufficiently collateralizes the note and whether it could be recovered and sold upon foreclosure to pay off the indebtedness. In this case, no increase in the risk was deemed warranted.

6. Personal Guarantee – Bank loans typically require a personal guarantee by the issuer. The net worth of the issuer is important in gauging the impact of the personal guarantee on the risk of the note. In our example, the note is not personally guaranteed. Therefore, the risk of the note was increased for this factor.

7. Marketability – Unlike a publicly traded bond, a privately held note would take time to sell to a third party or interested investor. Since our note in the example is privately held, the risk of an investment would be increased due to its lack of marketability.

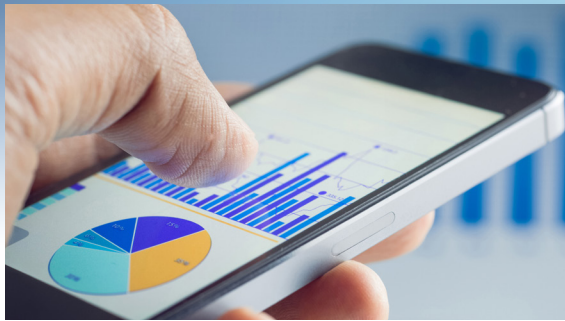
As mentioned previously, a specific risk premium can range from 2% to 6%, but can be higher. In this example, a specific risk premium of 4% was determined to be reasonable based on the above factors and was added to the base rate derived from the BDC's average current yield of 10.4% to calculate a market rate of interest. In this example:

Base Rate	10.4%
Incremental Risk	<u>4.0%</u>
Market Rate of Interest	14.4%

Based on discussions with professionals who buy and sell notes, the market rate of return for a privately held note typically ranges from 12% for a well collateralized note with a strong payment history to 25% for an uncollateralized note. For our example, the market rate of interest of 14.4% falls within this range based on the risk analysis discussed above.

Calculation of Value

The final step of the calculation is to forecast the future interest and principal payments and determine their present value using the market rate of interest determined based on the above factors. As reflected below, the



It is important to remember that it is the risk of the note (reflected in the market rate of interest) that ultimately impacts the value of the note.

Figure 5. Present Value Calculation

Market Interest Rate = 14.4%

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Cash Flow Forecast	\$87,342	\$87,342	\$87,342	\$87,342	\$87,342

Net Present Value \$296,992

About the Author:

Bruce A. Johnson, ASA, is a partner in the business valuation firm of Munroe, Park & Johnson, Inc. located in San Antonio, Texas. He may be contacted at bruce@mpjonline.com

¹Shannon Pratt, *Valuing a Business*, 3rd ed., (Homewood, IL: Richard D. Irwin, Inc., 1996), 24.

principal and interest payments are forecast to be \$87,342 for each of the next five years based on the terms of the note. Discounting the future principal and interest payments to present value using the market rate of interest of 14.4% results in a value of \$296,992.

The market value represents a 25.8% discount from the balance of \$400,000 [$1 - (\$296,992 \div \$400,000)$].

Key Issues to Consider

This article discussed the key issues to consider when valuing a privately held promissory note. Even though the taxpayer and the IRS are primarily concerned with the discount from the note's balance, it is important to remember that it is the risk of the note (reflected in the market rate of interest) that ultimately impacts the value of the note.

Ultimately, the discount is the result of the calculation of value and not the driving factor. Some notes will trade at large discounts and some notes will trade at small discounts. This is a function of risk and return.

So, when conducting or reviewing a note appraisal, the reasonableness of the result should not be measured by the discount. Instead, the market rate of interest should be the measure of reasonableness and should be adjusted to an appropriate market rate by considering the risk of the investment from the viewpoint of a third party.



**2019
Tax Practitioner
Workshops**

October, November and December

- | | |
|--|--|
| General Income Tax
(2 days - \$315) | Advanced Income Tax
(2 days - \$315) |
| Partnership Tax Issues
(2 days - \$435) | Texas State Tax Issues
(1 day - \$245) |
| Ethics for Texas CPAs
(4 hours - \$120) | Agricultural Tax Issues
(1 day - \$245) |

16 Hrs CPE, 13.5 Hrs MCLE credit for 2-day workshop
8 Hrs CPE, 6.75 Hrs MCLE credit for 1-day workshop
TSBPA Sponsor #00139; IRS Approved CE Provider #NXR57

www.taxworkshop.com

for dates, times, and online registration
Sponsored by the Texas Extension Education Foundation, Inc.