

Handling Hard-to-Value Assets

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Handling Hard to Value Assets

Hard to Value Assets

1. Closely Held Assets

- Closely Held Stock
- Partnerships
- Limited Liability Corporations
- Miscellaneous Holdings
- Notes, Mortgages, Etc.

Handling Hard to Value Assets

Closely Held and Natural Resources/Real Estate

1. Acceptance
2. Purchase
3. Valuing
4. Fees
5. Monitoring Transactions
6. Managing
7. Sale

Handling Hard to Value Assets

Risks Associated Holding Unique Assets

1. Reputational Risk

- Is there a potential of external fraud managing the asset.
- Are there associations with the asset that would cause reputational issues.
 - Ethical
 - Value Conflict
 - Potential for Negative News

Handling Hard to Value Assets

2. Operational Risk

- Is there infrastructure to manage the asset
 - Technology Resources
 - Human Resources
 - Economically Feasible
 - Is it possible to outsource?

Handling Hard to Value Assets

3. Compliance Risk

- Associates Serving on the Board
- Conflicts of Interest
- Other

Handling Hard to Value Assets

4. BSA/AML Risk

- Know Your Customer
 - Understand the Complex Ownership Structure
 - Determine Who is Controlling the Entity
- Understand the Nature of the Business
 - Dealing With OFAC Sanctioned Countries
 - Dealing With OFAC Sanctioned Individuals

Closely Held

1. Accepting the Business

- Implement a Sustainable Uniform Acceptance Process
- Working Group or Committee Approval
 - Latest audited Financial Statement, or latest unaudited Financial Statement
 - By-Laws of the corporation and any shareholder agreements; Operating Agreement
 - Number of shares of corporation owned by the trust and number of shares of the corporation outstanding
 - Names of the owners of the company and number of shares owned by each
 - Most recent market value of the stock, method of determination of value, and the date of valuation
 - Income Paid Out
 - Dividends, Succession Plan

Closely Held

2. Valuing

- Internal Valuations
 - Most Common Three Approaches
 1. Income Approach
 1. Methods to Value the Income Stream
 2. Market Value Approach
 1. Compare to Similar Companies' Traded Value
 3. Asset Value Approach
 1. Based on Underlying Assets
 1. Real Estate
 2. Marketable Securities
- External Valuations
 - Use of External Appraisal Firm
- Blended Approach
 - Use Internal Valuations if Feasible
 - Outside Valuation is Used When Internal is not Supported

Monitoring Transactions for Fraudulent Activity

- Purchases and Sales
 - Possibly Lower Risk than Transfers
 - Generally Approved by Working Group or Committee
 - Documented with Contracts and Paper Trails
- Transfers Among Accounts
 - Understanding Purpose
 - Velocity

Natural Resources/Real Estate

Various Types of Natural Resources and Real Estate

1. Real Estate
2. Timber and Timberland
3. Oil/Gas and Minerals
4. Farmland
5. Looking ahead; Carbon Credits?



Natural Resources/Real Estate

Natural Resources and Real Estate

- Accepting the NRRE/RE Asset
 - Super Fund sites!
 - Visual Inspection
 - Working Group/Committee Approval
- Fiduciary Acceptance and Risks
 - Understanding the Relationship/Co-Fiduciaries
 - Reviewing the Agreement
 - Special Instructions, Restrictions, Trustee Powers
 - Understanding How to Apply Income
- Obtaining and reviewing all available information on the assets
 - Opinions of Title (Breaks in the chain of title/liens, etc.)
 - Title insurance policies
 - Copy of the deed(s)
 - Maps, surveys, photographs, etc.
 - Current lease agreements and/or contracts

Natural Resources/Real Estate

- Managing the Assets
 - Protecting Assets From Loss of Value
 - Producing Sustainable Income
 - Valuing the Assets
 - Routine Account Reviews
 - Routine Asset Reviews

Natural Resources/Real Estate

- Protecting Assets from Loss of Value
 - Casualty, liability, and crop insurance coverage (previously had timber casualty insurance coverage)
 - External policies from tenants
 - Routine On-the-ground-Inspections
 - Theft
 - Encroachment
 - Unauthorized Dumping

Natural Resources/Real Estate

Producing Sustainable Income

- Sale Of Real Property
- Commercial/Residential Rent
- Recreational Leases
- Timber Income
- Crop Income
- Mineral Income

Valuing the Assets

- Preferred to be Obtained from External Resources
 - Licensed Experienced Appraisers
 - Internal Appraisals
 - Generally Performed on Assets in Fiduciary Accounts Held over a Long Time Frame
 - No Serious Property Management Decision made on Internal Appraisals.
 - Combination of sales, cost, income or tax assessor's value
 - Master narrative appraisal report covering all minerals

Natural Resources/Real Estate

Routine Account Reviews

- General Account Reviews
 - Administrative Review
 - Best Practice to have an Automated System to Identify NRRE Assets
 - Ensure Annual NRRE Review Was Performed
 - Ensure any Issues Are Addressed
 - Ensure Expected Income Etc. has Posted to Account
 - Annual Investment/Reg 9 Review
 - Ensure All of the Assets Are reviewed in Whole Annually
 - Evaluate Holding the Asset is Still inline with Overall Investment Objective

Natural Resources/Real Estate

Routine Asset Reviews

- Physical Inspection
 - Access the Condition of the Property
 - Access any Physical Changes
 - Note any Changes in the Area
 - Could Affect Highest and Best Use
 - Inspection for Environmental Problems and Risks
- Ensure Insurance Coverage is Adequate and Premium Paid
 - If Economically Feasible, assess if additional types of insurance is available
- Leases are Up to Date and Accurate

Natural Resources/Real Estate

- ▶ Environmental Problems and Risks
 - ▶ Under/above ground storage tanks
 - ▶ Used tires
 - ▶ Retired batteries
 - ▶ Chemical storage
 - ▶ Adjacent land use (land fill, dry cleaner, etc.)
 - ▶ Known Threatened/Endangered Species present on the property
 - ▶ Easements that encumber the property

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Studies

- Regions Timber Funds
 - Timber investments are diversified, holdings are spread across multiple states in the Southeast
 - Standing Timber Casualty Insurance Company
 - Economically Feasible, \$.50 per acre of timber
 - Regions Timber Funds decided to cover the timber holdings in funds
- Snowmeggedon 2014
 - Ice storm that caused \$1,000,000.00 damages to Timber in Fund
 - Was able to recoup \$750,000.00 after deductible
- Insurance Company no Longer in Business
 - 2018 Hurricane Michael
 - 1.3 billion dollars in timber losses in N. Florida

Studies

A Perfect Storm of Events, Story of 3 Trusts, 2 Wells

- Two related trusts Receiving Royalties from 1 well.
- Another trust administered at same bank receiving royalties from an adjacent well using same extraction company.
- Energy extraction company goes through a merger.
 - Error occurs in royalty payments during merger.
 - Royalties for both wells are paid to trust associated with the adjacent well.
- Error goes undetected by trustee.
 - Annual Review Issue
 - Manual process to reconcile royalty income.

Studies

Multiple Royalty Leases

- Due Diligence on Acceptance on Asset
 - Discovered Client Had 4 Leases on Same Well
 - Mineral Specialist Reviewed All Leases
 - Discovered Lessor did not follow provisions of 1 Lease
 - Missed Milestone Payment
 - Was able to get out of 3 Leases
 - Highlights the importance of having adequate infrastructure to manage business

Studies

Real Estate Not Removed from an Estate

- Real estate sold during the administration of the Estate
 - Not removed from estate account after sold
 - Resulted in higher estate taxes
 - Higher Estate Administration Fees
 - Real Estate transferred to pour over trust
 - Caused higher fees in pour over trust
- Lessons Learned
 - Better Structure Around Estate Administration
 - Central Estate Administration Group
 - Checklists and Regular Administrative Reviews
 - Structured Real Estate Removal Process
 - Checklists and Post Sale Reviews

Studies

Kress v. United States

- Established Price of 1.2x book value for shares sold to employees or directors
- Transfers to family members restricted
- Minority interest gifts were made to children and grandchildren
 - Relied on appraisals from seasoned business appraiser
- IRS assessed a deficiency on gifts
- Three different valuation methods were argued in court
- Court ruled the burden of proof shifted to the Government
- The court adjudicated largely in the taxpayer's favor

Questions?

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