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Transparency in Collaboration

Principles of Transparency Specific to Valuation Premiums and Discounts

Part 6 of 7 in a Series
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Summary

This is the sixth of a series of articles discussing and setting forth principles of transparency related to business valuations and financial analyses performed in a collaborative process setting. This article will propose principles for transparency specific to business valuation premiums and discounts.

In the first article of this series, I proposed specific principles of transparency applicable to a financial analyst, including a business valuator, working in a collaborative process. The specific principles proposed are designed to allow the verification, reproduction, and evaluation of findings and conclusions and include:

- Clarity of scope of roles, responsibilities and objectives,
- Open process for formulating reporting,
- Public availability of information,
- Accountability and assurance of integrity,
- Shared vocabulary,
- Benchmarking or verification of work performed, and
- Fees based on time and materials.

While there has been much talk about transparency, most has been quite general. My proposals are intended to form a basis for discussion and development. This series of articles focuses on the application of these principles to a financial expert performing a business valuation.

Overview

Over the last several months, these articles have discussed valuation approaches and empirical data. It is now time to discuss adjustments to the value of a business based on factors such as marketability, controlling interest, and voting rights. Each business valuation is unique, thus the valuer will not consistently apply the same discounts to each valuation. In some cases no adjustments will be needed, in others a combination will apply. The various premiums and discounts are dependent on the specific methodology used in the valuation (i.e., Income Approach, Cost Approach, and Market Approach). The ownership characteristics of the value (e.g., control/non-control, marketable/non-marketable) affect the premiums and discounts appropriate for the valuation.

Marketability

An adjustment made based on marketability is in most cases a discount. Because there is a substantial difference in the marketability of an interest of a publicly traded company and a closely held one, the shares of the closely held company tend to be less valuable than their counterparts in the public markets. Marketability relates to (but is not exactly the same as) the liquidity of an investment. All other things being equal, a liquid investment will command greater value than an illiquid one.

The lack of marketability discount measures the difference in value between two securities according to liquidity or its ability to be converted into cash. Many factors affect the liquidity of an investment, among them are:

- Number of shareholders,
- Size of the block of stock being valued,
- Restrictions on sale of the stock by agreement or law, and
- Absence of registration.

Guidance as to the proper level of discount can be found in empirical research studies. These studies typically approach the question of "how much" from several different perspectives. One approach is to analyze the differences in prices between publicly traded securities and those of restricted stocks of the same companies. Since a letter stock is identical to the traded stock in all respects except marketability, the difference in price highlights the lack of marketability discount. Several prominent studies identified discounts with a mean in the range of 30% - 40% for prices of non-marketable stocks in comparison to marketable shares that were otherwise identical. A proprietary study by The Financial Valuation Group reflected a mean discount of 33%.

A second approach is to analyze the relationship between the price at which shares were initially offered to the public and the prices at which shares had been traded privately in the five months preceding the public offering. A study by Robert W. Baird & Co., which covered four periods in the 1980s [1], indicated average discounts ranging from 43% - 60% with a weighted average discount of 47%. An unpublished study by Willamette Management Associates, Inc., over the period 1975 to 1985, reflected median discounts in the range of 49.4% - 80.0%.

Columbia Financial Advisors, Inc. (CFAI) conducted a study recently of the sale of restricted securities in the U.S. reflecting the changes in Rule 144. Specifically, Rule 144A allows acceleration of the sale of the restricted stock from two years to one year. CFAI examined only private common equity placements over the period January 1, 1996 through April 30, 1997. The study, written by Kathryn F. Aschwald, states:

> "...analysis of these transactions led to the following observations. First, the exchange on which the issuing company's non-restricted stock is traded seemed to have an impact on the size of the discount, with the highest discounts generally seen for those issuing companies whose stock was traded on the OTC and Small Market Capitalization markets. The average discount for all 23 transactions was approximately 21%. The average discount for those eight transactions that we were specifically able to verify to involve restricted and/or unregistered securities was 26%. The average discount for those issuing companies whose stock was traded on the NASDAQ, OTC, and/or Small Market Capitalization markets was 23%. For all 23 transactions, the discounts ranged from 0.8% to 67.5% and the median was 14%."
>
> "...the discounts for restricted securities have generally declined since 1990 as the market (and liquidity) for these securities has increased due to Rule 144A and the shortening of restricted stock holding periods beginning April 29, 1997. Thus, while the newer studies are specifically relevant for determining the appropriate discounts for restricted securities, the studies conducted after 1990 are not relevant for purposes of determining discounts for lack of marketability for privately held stock, because they reflect the increased liquidity in the market for restricted securities. Such increased liquidity is not present in privately held securities." [2]

Controlling Interest

Value must reflect the elements of control. These elements allow the controlling shareholder to unilaterally:

- Elect directors and appoint management,
- Determine management compensations and perquisites,
- Declare and pay dividends,
- Sell or acquire treasury shares,
- Set policy regarding the course of business,
- Make acquisitions,
- Select parties with whom to do business and award contracts,
- Change articles of incorporation and bylaws, and
- Liquidate, dissolve, sell out or recapitalize the company.

Premium for controlling interest

There are various studies which provide guidelines for establishing an appropriate control premium. Studies published in Merrill Lynch Mergerstat Review note median control premiums paid over market prices for public companies over the period of 1987 through today range from 27.3% - 35.0%. Published studies by Houlihan, Lockey, Howard & Zukin, Inc. (HLHZ) in the Control Premium Study indicate that the median control premium paid in the 23 transactions for the trailing 12-month period (July 1, 1996 to June 30, 1997) was 27.1%.

Discount for lack of control

The sources of research on the impact on market value of lack of control alone, excluding marketability factors, is both scarce and difficult to apply to a closely held investment partnership. The lack of control adjustment is not based upon any single calculation in the analysis. Historical real estate investment trust (REIT) data indicates that the market has accorded a discount for lack of control of 10% - 20% recently, but as high as 48% in October 1990. The average benchmark for this discount as provided by Mergerstat Review has been 20% - 25% and by HLHZ 14% - 17%.

Voting Stock

There is some evidence that there is a premium placed on stocks which include special voting rights, as compared with otherwise similar stock without the same voting rights. However, where the transactions represent only a small minority of the voting class of stock, the premium accorded the shares is comparatively insignificant.

A recent proprietary study by The Financial Valuation Group identified over 40 companies whose stock traded in two classes on listed exchanges. In each case both the voting and non-voting stock were offered side by side in their various markets. The list was ultimately reduced to the stock of 20 companies where the only difference between the shares was the voting rights. The dividends were the same and the shares were equal in all respects, with the exception of voting rights, where the Class A shares were typically granted four to ten times as much voting power per share as the Class B shares. The study seems to indicate that where the shares traded represented only a minority interest, little added value (generally 1% - 2%) was placed on the voting shares by the marketplace.

Conclusion

The types and amounts of appropriate discounts or premiums are often major matters of dispute in the resolution of business valuation controversies. When dealing with discounts and premiums, it is critical that the valuer be exact as to the base of value to which the discount or premium applies. An understanding of the facts and circumstances is essential, along with strong supporting data and careful reasoning. Conclusions must be objective and consistent with applicable statutes and legal precedent.

Next month, the final article of this series will provide suggested checklists for use by lawyers and non-appraisers.

Endnotes:

[1] Although dated, the studies presented are still considered relevant today. This is due to their results as well as the empirically derived rationale for the results. Over several decades, empirical research on these matters has shown consistent results.

[2] "Restricted Stock Discounts Decline as Result of 1-year Holding Period", Shannon Pratt's Business Valuation Update, Vol. 6, No. 5, May 2000

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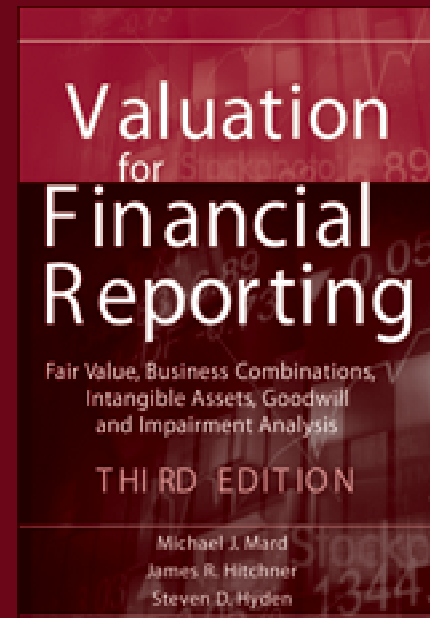

Michael Mard, among many others, was involved in the creation and development of SSVS. If you would like an electronic version of SSVS, email info@fvgfl.com and a copy will be provided to you. Please put "SSVS Copy" in the subject line.

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