

Introduction to Minority Interests (DLOC & DL0M)

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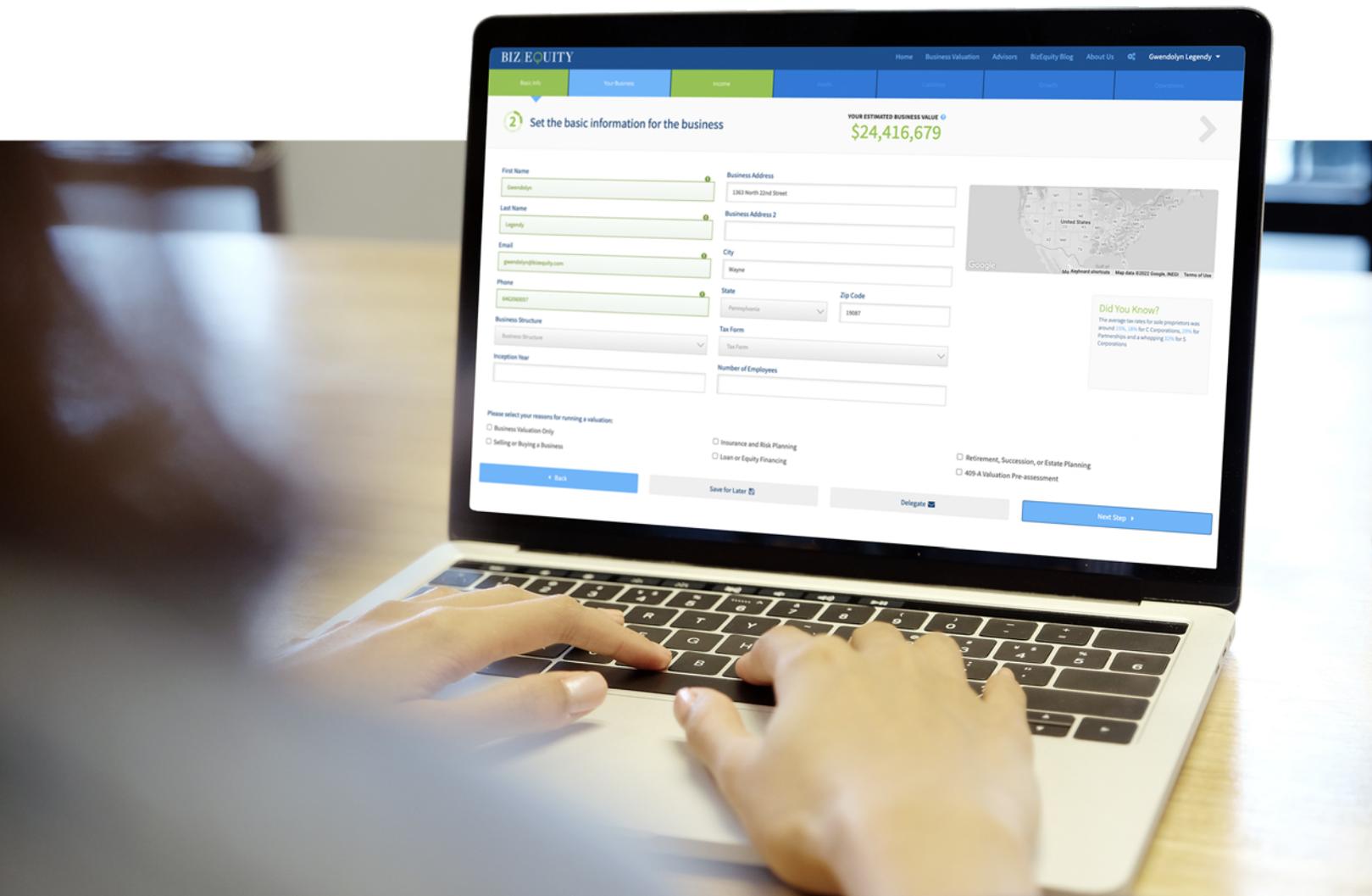
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Introduction to Minority Interests (DLOC & DLDM)



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This whitepaper introduces and elaborates on those factors which influence the determination of the final discounts for lack of control (DLOC) and for lack of marketability (DLOM).

As stated, the two primary discounts to be applied against the subject firm's controlling interest value are reflective of the following definitions:

1. The minority shareholder discount (DLOC) is designed to reflect the decreased value of shares/shares that do not convey control of a closely held corporation.
2. The lack of marketability discount (DLOM) is designed to reflect the fact that there is no ready market for shares/shares in a closely held corporation.

In short, a 10% minority interest is not worth 10% of the marketable, control value generated by the BizEquity 7-Step tool. Such non-controlling interests are worth less due to differences involving control and marketability. Based on the specific valuation use case and the corresponding user input, either or both of the discounts were assessed and applied to reach a final estimate of equity value on a per unit basis.

Among the general factors which impact the level of such discounts, appraisers will seek to review the following:

- The difficulties faced by owners of fractional interests in securing purchasers except at substantial discounts;
- The limits placed on owners of fractional interests with respect to control, management, and operation of the property;
- The inconvenience of dealing with multiple owners;
- The possibility of complications caused by owners of very small fractions; and
- The danger of partition suits.

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DLOC Factors

The BizEquity Benchmark DLOC is assumed to be 25%, consistent with long term averages as exhibited or observed in the market for corporate control throughout the US. Note that the DLOC is considered to be the inverse of the so-called “control premium” that is paid to obtain the benefits of control.

The specific factors within the BizEquity framework which will drive the determination of the actual final DLOC are as follows:

1. Voting Rights (or lack thereof)
2. Relative % of Ownership
3. Swing Vote Attributes
4. Operational Role of Minority Owners

DLOM Factors

The BizEquity Benchmark DLOM is assumed to be 35%, consistent with measures of central tendency as exhibited in numerous independent benchmark studies, e.g. restricted stock and Pre-IPO studies. Some appraisers break this discount into two components; one for lack of liquidity (ease of conversion into cash) and one for lack of marketability (ease of transfer).

Barron’s Dictionary of Business Terms defines marketability and liquidity as follows:

"Marketability is the speed and ease with which a particular security may be bought and sold. A stock that has a large amount of shares outstanding and is actively traded is highly marketable and also liquid. In common use, marketability is interchangeable with liquidity, but liquidity implies the preservation of value when a security is bought or sold."

The specific factors within the BizEquity framework which will drive the determination of the actual final DLOM are as follows:

1. Voting Rights (or lack thereof)
2. Percent/Consistency of Distributions
3. Expected Holding Period
4. Contractual/Regulatory Restrictions

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Considerations of Key DLOC Determinants

Voting Rights (or lack thereof)

Some firms have more than one class of equity. One example of “dual classes” involves voting versus non-voting units. Typically, non-voting shares are subject to a per unit discount of 0% to 10% with the BizEquity tool based on a 5% positive increment to the benchmark DLOC for voting shares. Note that this factor is a standalone adjustment to the initial benchmark DLOC of 25% whereas the impact of the remaining three factors are summed into an overall “net” adjustment to reach the final DLOC.

Relative % of Ownership

In general, per share value will rise as the relative share of ownership increases (and vice-versa), i.e. the applicable discount will decline. As the minority interest rises from 1% to 50%, the pertinent discount is reduced (and per unit value is increased) due to “more control”. The tool provides for an adjustment ranging between plus 15% (very minimal ownership) and negative 15% (ownership approaches 50%). If the interest is over 50%, the prerogatives of control are available and no DLOC is applied.

Swing Vote Attributes

This attribute is present when a given interest is sufficient to exercise control upon teaming up with one or more other owners. Even a 1% interest may possess swing vote power if there are two other owners with 49.5% ownership each. In effect, a swing vote premium serves to lower the overall DLOC as otherwise determined by as much as 15%.

Operational Role of Minority Owners

The more active an employee/owner is in shaping company policy and impacting operational and financial decision-making, the more “control” is assumed to exist. The spectrum of impact for this factor ranges between minus 10% and plus 10%.

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Considerations of DLOM Determinants

Voting Rights (or lack thereof)

Some firms have more than one class of equity. One example of “dual classes” involves voting versus non-voting units. Typically, non-voting shares are subject to a per unit discount of 0% to 10% with the BizEquity tool based on a 5% positive increment to the benchmark DLOC for voting shares. Note that this factor is a standalone adjustment to the initial benchmark DLOC of 25% whereas the impact of the remaining three factors are summed into an overall “net” adjustment to reach the final DLOC.

Percent/Consistency of Distributions

The higher the payout ratio (% of profits distributed to owners) and the more consistent this payout over time, the more marketable a minority interest becomes. If a majority of profits are distributed regularly, the DLOM is reduced by up to 15%.

Expected Holding Period

The expected holding period for the minority investment has a direct influence on the amount of the DLOM. As the holding period grows from less than one year to four years, the discount will decline up to 10% (on a sliding scale) whereas a holding period between 4 years and 10 years will cause the DLOM to increase by up to 10% (on a sliding scale). The longer it takes to sell an asset, the higher the presumed risk due to illiquidity.

Contractual/Regulatory Restrictions

This adjustment relates to several possible components of the firm’s operating documents including the articles of incorporation, operating agreement, buy-sell agreement and state law provisions. Any impediment to the free and open sale and transfer of a minority interest serves to elevate the pertinent DLOM (and vice-versa). If such factors exist which make the sale or transfer more difficult, the DLOM is increased by up to 10% (and decreased by up to 10% if no such impediments exist). Common examples which may involve restrictions on the sale of a minority interest include:

1. Put rights such as tag-along rights
2. Prohibition of transfer (absolute or to designated parties), including required approval of other owners or board of directors (rights of first refusal)
3. Stock restriction agreement or lockup agreement
4. Preemptive rights
5. Forced sale through drag-along rights of majority owner

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Estimation of DLOC

Whether or not the ownership interest being valued has control over the subject company can have a meaningful impact on its value. Controlling owners have the ability to:

- Elect directors or appoint management;
- Set levels of management compensation and other perks;
- Determine cash dividends/distributions;
- Set company policies or business course;
- Purchase or sell assets; and
- Determine when and how to sell the company.

According to Mergerstat, acquisition control price premiums offered over the past 10 years translate to discounts for lack of control of approximately 20 percent to 30 percent. A rough midrange would be around 25%.

The key factors impacting the DLOC include:

- Percent of ownership?
- Swing vote capability?
- Role of minority shareholders in day to day operations and strategic planning?
- Voting versus non-voting rights and other facets of capital structure and articles of incorporation/organization?

Estimation of DL0M

Clearly, the ability to convert an investment from an illiquid asset to cash is an ownership characteristic of considerable value. Often, when this trait is missing, an investor is subject to substantially higher risk, and valuation of the attendant equity interest must be adjusted accordingly.

Marketability, as a business valuation concept, has been defined a number of ways in business valuation treatises. Dr. Shannon Pratt et al define marketability as:

“The ability to convert the business ownership interest (at whatever ownership level) to cash quickly, with minimum transaction and administrative costs in so doing and with a high degree of certainty of realizing the expected amount of net proceeds.”

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According to the IRS Job Aid for Valuation Professionals:

- DLOM is appropriate when the subject interest is non-marketable, yet the prior steps in the valuation process result in a marketable value.
- DLOM is not appropriate if the prior valuation process has already taken marketability concerns into consideration.
- DLOM is applied after the minority interest discount or control premium where such is appropriate to a valuation problem.
- DLOM should be determined on its own factors and not combined with other discounts.

Another perspective for evaluating the DLOM is presented next:

1. Factors That May Increase the Discount

- Restrictions on transfers
- Little or no dividends or partnership payout
- Little or no prospect of either public offering or sale of company; especially if so stated in corporate minutes or other documentation
- Limited access to financial information

2. Factors That May Decrease the Discount

- “Put” option
- Limited market available that may be interested in purchasing shares (e.g., ESOP)
- Imminent public offering or sale of company
- High dividend or partnership payouts

3. Factors That May Increase or Decrease the Discount

- Size of block – depending on size and circumstances
- Buy-sell agreement – depending on provisions

Various “Restricted Stock” studies have shown average DLOM levels of between approximately 20 percent to 25 percent for transactions occurring after 1990. Median price differences between private transaction prices and public market prices (so-called “Pre-IPO” Studies) varied under different market conditions, ranging from about 40 to 60 percent, after eliminating the “outliers.” A rough midrange might be around 35%.

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