

THE LEVELS OF VALUE IN BUSINESS VALUATION. THE DISCOUNT FOR LACK OF MARKETABILITY

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Abstract:

This paper approaches the subject of levels of value used in business valuation and adjustments (discounts and prime) that enable professional business valuers to relate these in order to determine the value of a business or ownership interests in a business. Marketability and control over business decision have a profound impact on the value of an ownership interest. Valuers, regularly, reduce the value of an investment interest if it lacks a ready market. In this paper, I highlight the difference between the marketability and liquidity and, the differences between the discount for lack of marketability and discount for lack of control. A discount for lack of marketability is closely associated with, but, conceptually, distinct from, the discount for lack of control. I present the characteristics of discount for lack of marketability and the rational of applying it in valuation of minority and majority interest.

Key words: value, discount, marketability, control, interest.

JEL classification: G32

1. Introduction

When business owners think about the value of their business, they are almost always implicitly thinking about the value of the business in its entirety. In this case the value of a single share, for example, is the value of the whole business divided by the number of shares.

Many times, valuation cases do not imply estimation of the value of a company but the value of the blocks of shares in a company. The determination the value of a stock through dividing the value of the whole business by the number of common shares may not be an accurate method if the block of stock under consideration does not assure the control on the enterprise.

Many times, interests in businesses are often held directly by multiple owners. In this case one owner has only a fractional (partial) interest in an entity. Fractional interest valuation implies determination the value of ownership of a portion of a corporation. A fractional ownership interest may be worth less than its proportional share of the total business. For example, ownership of a 20% share in the business may be worth less than 20% of the entire company value.

The market values of these fractional interests are generally discounted from their proportional share of the whole. The degree of value reduction for fractional interest is determined, primarily, by whether or not it is a controlling interest. Secondly, the degree of value reduction for fractional interest is determined by whether or not it is a marketable interest. Function of the percentage owed there are two categories of *fractional interest* in a business: *majority (controlling) interest* and *minority interest* (non-controlling interest). Function of ease with which the interest can be transformed in cash there are, also, two categories of *fractional interest* in a business: *marketable interest* and, *non-marketable interest*.

2.The Levels of Value in Business Valuation.

Previous Research

Levels of value are conceptual points at which can be calculated the value of business interest. Marketability and control over business decision have a profound impact on the value of an ownership interest. There are four basic levels of marketability and control:

- the marketable controlling interest (a controlling share in a public company)
- the non-marketable controlling interest (a controlling share in a private company)
- the marketable minority interest (minority share in a public company)
- the non-marketable minority interest (a minority share in a private company)

A majority interest versus minority interest

For valuation purposes, *the concept of control* or, *absence of control*, relates to a shareholder's ability to influence, respectively, do not influence, the company's affairs. The determination of whether the valuation should be on a controlling interest or minority interest basis is a very important aspect. Shares may be subject to premium or discounts, depending upon whether they represent controlling or minority interests.

The concept of "business value" reflects the value of the 100% interest representing total control (Howitt, Idelle A. 1993). This is a usual indicator of a company value for merger or sales purposes. It is the value of the business as a whole. A "control interest" is defined as ownership of more than 50% of the business. These two positions (100% interest and, more than 50% of the business) also are known as majority interest positions.

The majority interest in a corporation is the ownership of an amount of stock which does enable the holder to exercise the control. *A minority interest* in a corporation is the ownership of an amount of stock which does not enable the holder to exercise the control. Generally, *a minority (non-controlling) interest* is defined as less than 50% of the total equity held. An investor has a minority interest in the firm if he held small blocks of stock that represent less than 50% of the company's equity, and usually much less than 50%.

A marketable interest versus non-marketable interest

For valuation purposes the concept of *marketability* or, *lack of marketability*, relates to a shareholder's ability to transform its interest easily in cash. The determination of whether the valuation should be on a marketable interest or nonmarketable interest basis is other very important aspect. Shares may be subject to discount that adjusts for degree of marketability. In general, investors value marketability. Therefore, other things being equal, investors will pay more for an asset that is readily marketable than for an otherwise identical asset that is not readily marketable. All other factors being equal, an interest in a publicly traded company is worth more because it is readily marketable (an owner can sell his/her shares on the stock market). Conversely, an interest in a privately held company is worth less because no established market exists.

2.1 The Concept of Marketability. The Marketability versus Liquidity

According with International Glossary of Business Valuation Terms the marketability is defined "the ability to quickly convert property to cash at minimal cost". The concept of marketability centres on the ease with which the holder of a stock ownership

interest can convert the security to cash in terms of timing, the reliability of realizing the quoted proceeds, and transaction costs (Ronald D. DiMattia, 2008).

The terms of liquidity and marketability are often used interchangeably, although there is a “technical distinction” between them (DLOM Job Aid, 2009).

Marketability is similar to liquidity, except marketability simply indicates that the security can be bought and sold easily, whereas liquidity implies the value of the security is preserved.

Marketability is the capability and ease of transfer or, saleability of an asset (DLOM Job Aid, 2009). Marketability may be defined as a measure of the ability of a security to be bought and sold and to be converted into cash quickly and at minimal cost. Therefore, if an active marketplace for a security exists, it has good marketability. The marketability can be restricted by agreements and regulation (DLOM Job Aid, 2009).

Liquidity is the ability to readily convert the asset into cash without significant loss of principal. Liquidity centres on the ability to find a buyer.

Marketability indicates the fact of “Saleability”, while Liquidity indicates how fast that sale can occur at the current price. Between marketability and liquidity there are the following relationships (DLOM Job Aid, 2009):

- if an asset is liquid, it is marketable;
- if an asset is not marketable, it is illiquid;
- if an asset is illiquid does not necessary mean that it is non-marketable – it may still be sellable but not quickly or without loss of value.

Pratt and Reilly (2000) distinguish marketability and liquidity as follows: “...with marketability focusing on finding the appropriate market, preparing the property for sale and executing the trade, and liquidity focusing on realizing cash proceeds.”

2.2 The Discount for the Lack of Marketability

The control premium and *the marketability discount* are conceptual adjustments enabling professional business valuers to relate the marketable minority level of value with the controlling interest level (control premium) and, nonmarketable minority level (marketability discount). *The minority interest discount* relates the controlling interest and minority levels. According with the International Glossary of Business Valuation Terms, Discount for Lack of Marketability (DLOM) is “an amount or percentage deducted from the value of an ownership interest to reflect the relative absence of marketability.”

The DLOM is a downward adjustment to the value of an investment to reflect its reduced level of marketability. Studies have shown that, because investors are risk averse, they apply a considerable discount to stocks that are not freely tradable. The inability to readily sell a financial interest significantly reduces its value.

Valuators regularly reduce the value of an investment interest if it lacks a ready market. As part of the appraisal process, the appraiser must determine the appropriate discount for lack of marketability that should be applied to a specific business ownership interest (DLOM Job Aid, 2009). The application of the Discount for Lack of Marketability (DLOM) can result in a significant value reduction as compared to the pro rata value of a business interest. The DLOM can be the valuation adjustment with the largest monetary impact on the final determination of value. The application of DLOM can be a crucial aspect in the valuation of the stock of a privately held company because many valuation methods used by appraisers determine the obtaining a marketable indication of value (Ronald D. DiMattia, 2008). Values derived from methods that apply aspects of securities of publicly traded companies result in what is termed a “publicly traded equivalent value”.

3. The rationale for DLOM. The comparison of Discount for Lack of Marketability with Discount for Lack of control.

The Results of Research

A discount for lack of marketability is closely associated with, but conceptually distinct from, the discount for owning a non-controlling interest. The marketability of stock shares is a concept that is distinct from the level of control, but related to it. It is well known that the shares of the closely held firms do not have the liquidity of the publicly held companies. The level of marketability associated to shares of the closely held companies is influenced by the level of control.

The marketability of a controlling interest in a private company is affected by two factors: *the transaction time* and *the transaction costs*. The owner of a controlling interest in a private company may incur, firstly, a *significant period of time* to sell its part. This situation is due to the fact that there is not a ready market for controlling interest in the companies. The unknown time for a sale is considered the fundamental rationale for discounts for lack of marketability. It may take months or years to sell an entire private business and it is almost impossible to sell minority (less than 50%) interest (Rand M. Curtiss, 2009). Secondly, the owner of a controlling interest in a private company may incur significant costs associated to selling. These costs will be of two types: direct costs of the sale and, the opportunity costs. *The direct costs of the sale* are represented by *legal, accounting and transaction fees*. *The opportunity costs* are represented by the cash-flows on alternative investments that are given up by the seller as result of his incapacity to sell in short time.

The minority interests in closely-held companies tend to be *much* less marketable than majority interests. Frank C. Evans (2011) put the question: „who wants to buy a minority interest in a private company where there may be little or no assurance of any annual cash return on their investment and little or no market available for a resale of those shares?“

The marketability of a minority interest in a private company is, also, affected by the transaction time and transaction costs associated with selling but appear another important element that must be taken into consideration. This is lack of transferability. Ownership interests in closely held businesses are frequently subject to agreements restricting their transfer. Often, transfers are restricted to family members, and other owners are the only permitted buyers of interests. These restrictions limit the pool of available buyers, further reducing liquidity and, implicit, the value. For most minority shareholders, sale must await action by the controlling stockholder, such as sale of the company. Frank C. Evans (2011) highlighted that: „The 100% control shareholder in the private company possesses relatively high liquidity: he or she can choose to sell the company, with marketability primarily determined by the time required to find a suitable buyer and close the deal and the associated transaction cost. This level of illiquidity often creates a discount that ranges from 3% to 15%. Conversely, the minority shareholder cannot force a sale of the company, frequently faces severe restrictions on the transfer of shares, and must find a buyer willing to invest in the unattractive lack of control interest. The result is severe illiquidity, which usually carries a marketability discount of at least 33% to 50% from a freely traded value.“(1).

The Discount for Lack of Marketability is deducted from the value of the entity as a whole. It applies to all shares, not just the minority stake being valued, to reflect the relative illiquidity of the shares compared to those of publicly traded companies. On the other part, the Discount for Lack of control is deducted from the proportionate share of the value of the minority stake being valued, to reflect the absence of control prerogatives.

The DLOM is applied after the minority interest discount or control premium.

Conclusions:

Fractional interest valuation implies determination the value of ownership of a portion of a corporation. A fractional ownership interest may be worth less than its proportional share of the total business. The market values of these fractional interests are generally discounted from their proportional share of the whole. The degree of value reduction for fractional interest is determined by the degree of control and degree of marketability. Levels of value are conceptual points at which can be calculated the value of business interest. Marketability and control over business decision have a profound impact on the value of an ownership interest. The DLOM is a downward adjustment to the value of an investment to reflect its reduced level of marketability.

The marketability of stock shares is a concept that is distinct from the level of control, but related to it. The level of marketability associated to shares of the closely held companies is influenced by the level of control. The marketability of a controlling interest in a private company is affected by two factors: *the transaction time* and *the transaction costs*. The minority interests in closely-held companies tend to be *much* less marketable than majority interests. The marketability of a minority interest in a private company is, also, affected by the transaction time and transaction costs associated with selling but appear another important element that must be taken into consideration. This is lack of transferability. Ownership interests in closely held businesses are frequently subject to agreements restricting their transfer. Often, transfers are restricted to family members, and other owners are the only permitted buyers of interests. These restrictions limit the pool of available buyers, further reducing liquidity and, implicit, the value.

Notes: (1)Frank C. Evans, Why 10% of a Private Company is Worth Less Than 10%, The Business Value Manager, 16 Aug 2011, pg.3.

"This work was supported by the project "Post-Doctoral Studies in Economics: training program for elite researchers - SPODE" co-funded from the European Social Fund through the Development of Human Resources Operational Programme 2007-2013, contract, no. POSDRU/89/1.5/S / 61755."

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