Demystifying Discounts for Lack of Control and Lack of Marketability

Presented by

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Introduction

HSSK, LLC is a valuation and dispute advisory firm whose principals have been in practice for over 40 years. Our valuation practice conducts valuation studies of all types of businesses and assets for a variety of purposes, including:

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Introduction

Sonia Desai, CPA, ASA, CPA-CA, CBV - received her B.Sc. in Commerce and Biology from the University of Toronto. She is a Certified Public Accountant (CPA) with the American Society of CPAs and an Accredited Senior Appraiser (ASA) in Business Valuation with the American Society of Appraisers.

Ms. Desai has over thirteen years of financial services experience, eleven years of which have been in valuation. She has testified on valuation issues and has served as a panelist and presenter to several legal associations, including the American Bar Association and Travis County Women Lawyers' Association. She has also authored several articles for publication in journals, including the CPA Insider, Austin Business Journal and Austin Lawyer.

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Introduction

David Butler, ASA, CPA - holds a Master's in Accounting from The University of Nebraska–Omaha, an MBA from Vanderbilt University, and a B.A. in Political Science and Economics from Millsaps College.

Mr. Butler has been involved in public accounting and the appraisal of businesses, business interests, intangible assets and securities within complex capital structures since 2002. He is a Certified Public Accountant and has earned the Accredited Senior Appraiser designation in Business Valuation from the ASA.

Mr. Butler is a member of the Texas Society of CPAs, the Houston CPA Society, the Houston Business and Estate Planning Council and the Houston Estate & Financial Forum. He is a past Chairman of the ASA's Energy Valuation Conference.

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Presentation Outline

- The Discounts Defined
  - Discount for Lack of Control (“DLOC”)
  - Discount for Lack of Marketability (“DLOM”)
- Basis in Finance Theory
- Empirical Studies

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Presentation Outline

- Are Empirical Studies Enough?
- Operating Agreements
  - Must-Have Provisions
  - Must-Avoid Provisions
- Takeaways
- Q & A

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The Discounts Defined: DLOC

A DLOC is formally defined as:

- *an amount or percentage*
- *deducted from the pro rata share of value of 100% of an equity interest in a business*
- *to reflect the absence of some or all of the powers of control.*

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The Discounts Defined: DLOC

- By this definition, a DLOC relates to the inverse of a control premium.
- What's a control premium? It's
  - *an amount (expressed in either dollar or percentage form)*
  - *by which the pro rata value of a controlling interest exceeds the pro rata value of a noncontrolling interest in a business enterprise*
  - *that reflects the power of control.*

Source: *International Glossary of Business Valuation Terms.*

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The Discounts Defined: DLOC

- Examples of powers of control:
  - Elect directors and select management
  - Determine business policies, direct daily operations and decide future plans
  - Amend or change articles of organization or bylaws
  - Set compensation and benefits received by management
  - Declare or pay distributions to members
  - Liquidate, dissolve, merge, sell or recapitalize the company
  - Dispose of or acquire certain assets

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The Discounts Defined: DLOM

- Marketability of an investment relates to its liquidity, or how quickly the investment can be converted to cash
- Illiquidity entails greater exposure to market volatility and higher risk, which therefore reduces (discounts) the value of the investment

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The Discounts Defined: DLOM

- A DLOM discount is a relative measure of illiquidity.
- The IRS defines lack of marketability as *"the absence of a ready or existing market for the sale or purchase of the securities being valued."*

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The Discounts Defined: DLOM

- Illiquid relative to what? The U.S. equity markets, where an investor can readily and inexpensively sell a publicly-traded stock for cash at a known, publicized price.
- Any circumstances short of this liquidity standard form the basis for a LOM discount.

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Basis in Finance Theory

- When someone makes an investment, they are foregoing consumption today in exchange for a higher return tomorrow.
- Investors have to be compensated for risk – the possibility that they won't realize a return on their investment.
- In the valuation world, risk is typically defined as the volatility of cash flows. Any factor that impedes the receipt of cash flows in a predictable, timely manner increases risk.

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Basis in Finance Theory

- Looking at DLOCs and DLOMs from a risk perspective helps us understand why they exist.
- DLOCs and DLOMs are additional compensation to an investor for taking on risk.
- A DLOC recognizes that a minority investor cannot influence activities that lead directly or indirectly to the timing or receipt of cash flows.
- A DLOM recognizes that investors in an illiquid investment cannot quickly convert their investment into cash.
- Type of asset being appraised can significantly impact the magnitude of DLOMs and DLOCs: the more time it takes to convert it to cash, the higher the discount.

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Basis in Finance Theory

DLOMs and DLOCs effectively increase an investor's rate of return to account for the fact that:

- They can't control cash flows
- They can't get to their money now

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Empirical Studies

- DLOC studies are typically based on transaction data
  - Control premiums published annually by Mergerstat (recently subject to considerable scrutiny and criticism).
  - Control premiums can also be derived using CapIQ and Closed-End Fund studies
  - From these, an appraiser derives a DLOC
  - DLOC can be estimated directly using an Asian put option model
  - Used in estate/gift tax and financial reporting engagements

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Empirical Studies

- DLOM studies are typically based on historical studies
  - Restricted stock studies

Name of Study	Study Years	Number of Transactions	Average Discount
SEC Institutional Investor Study	1966-69	398	25.8%
Nonreporting OTC Companies	1966-69	112	32.6%
Milton Gelman	1968-70	89	33.0%
Robert Trout	1968-72	60	33.5%
Robert Moroney	1968-72	148	35.6%
Michael Maher	1969-73	33	35.4%
Standard Research Consultants	1978-82	28	45.0% *
William Silber	1981-88	69	33.8%
FMV Opinion, Inc	1980-2012	782	18.5%
2 Year Holding Period	1980-1997	254	22.4%
1 Year Holding Period	1997-2008	380	18.9%
6 Month Holding Period	2008-2013	148	10.8%
Management Planning, Inc.	1980-96	53	27.1%
Bruce Johnson	1991-95	70	20.0%
Columbia Financial Advisors	1996-97	23	21.0%
Columbia Financial Advisors	1997-98	15	13.0%

** Median discount*

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Empirical Studies

- DLOM studies are typically based on historical studies
  - Pre-Initial Public Offering stock studies
    - John D. Emory
    - Valuation Advisors
    - Willamette Management Associates
  - Also substantial judicial precedent
    - Revenue Ruling 77-287
    - *Estate of Davis*
    - *Bernard Mandelbaum, et al. v. Commissioner*

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Are Empirical Studies Enough?

- *Bernard Mandelbaum, et al. v. Commissioner*
  - The Tax Court identified the restricted stock and pre-IPO studies as a starting point of reference and cited *nine factors* to consider when deciding on the magnitude of a LOM discount.

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Are Empirical Studies Enough?

- Financial statement analysis
  - Level and predictability of revenues and profits
  - Leverage in capital structure
  - Liquidity of underlying assets
- Dividend-paying capacity, history and dividend yield
- Nature of the Company and Its History, Industry Position and Economic Outlook

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Are Empirical Studies Enough?

- Analysis of Management
  - Quality, experience and stability
- Amount of Control in Transferred Shares
- Holding Period
  - Term of Partnership
  - Potential for IPO, Sale or Liquidation

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Are Empirical Studies Enough?

- Restrictive Transfer Provisions
  - Length of Restriction Period
  - Right of First Refusal (ROFR)
  - Transferee Restrictions
- Redemption Policy
  - Put Rights
- Costs Associated with a Public Offering

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Operating Agreement "Must-Have" Provisions

- Term
  - *The Company may be dissolved at any time by:*
    - *The unanimous written consent of all of the Partners;*
    - *the bankruptcy, insolvency, withdrawal or retirement of the General Partners if a new General Partner is not elected within sixty days; or*
    - *the sale or disposition of all Partnership assets.*

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Operating Agreement "Must-Have" Provisions

- Management authority
  - *The General Partners shall have full and complete charge of the conduct of all of the affairs of the Partnership to the exclusion of the Limited Partners.*
  - *The General Partners shall have the exclusive right and obligation to manage and control the business and affairs of the Partnership and to make all financial and operational decisions on behalf of the Partnership.*

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Operating Agreement "Must-Have" Provisions

- Withdrawal rights
  - *No Partner may retire or withdraw from the Partnership without the written consent of all other Partners, which consent may be withheld with or without cause.*

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Operating Agreement "Must-Have" Provisions

- Transfer restrictions
  - *No new Partner may be admitted to the Partnership without the written consent of all Partners, which consent may be withheld with or without cause.*
  - *Except as provided in this Article, no Member may transfer any Membership Interest either voluntarily or involuntarily by any means without the consent of the Manager. The Manager is not required to consent to any attempted transfer and will not be subject to any liability for withholding consent.*

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Operating Agreement "Must-Have" Provisions

- Right of First Refusal
  - *A Member or an Assignee may Dispose of all or a portion of his Membership Interest if he, prior to making such Disposition, first offers (an "Offer") such portion of the Membership Interest (the "Offered Interest") for sale to the Company and the other Members (the "Remaining Members"). The Offer shall be made for the price and upon the terms at which the proposed Disposition is to occur (the "Proposed Price"). The Offer shall be made by written notice…*

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Operating Agreement "Must-Have" Provisions

- Capital
  - *No Member shall have the right to withdraw all or any part of its Capital Contribution or to receive any return on any portion of its Capital Contribution, except as may be otherwise specifically provided in this Agreement.*
- Distributions
  - *The Manager shall determine the amount of the distributions of cash and/or other property to be made by the Company to the Members …Distributions shall be made at the discretion of the Manager.*

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Operating Agreement "Must-Have" Provisions

- Drag Along
  - *In the event that the Majority Member agrees to sell his/her interest in the partnership, the Majority Member shall have the right (but not the obligation) to initiate a sale of the partnership and to require each other Member to participate in a sale of the partnership on the same terms and conditions as the Majority Member…*

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Operating Agreement "Must-Avoid"

- Put rights
  - *The Stockholder shall have the right and option (the Put Option) to sell any or all of the Shares then owned by the Stockholder to the Company for a purchase price of $7.00 per share (the Per Share Put Price). The Stockholder may exercise the Put Option at any time during the Put Period by giving written notice of such exercise to the Company, specifying the number of Shares with respect to which the Put Option is being exercised (the Put Shares). In the event the Stockholder exercises the Put Option, the Company shall be obligated to purchase the Put Shares from the Stockholder for the Per Share Put Price.*

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Operating Agreement "Must-Avoid"

- Tag Along
  - *Each Member shall have the right to elect to (but shall have no obligation to) participate in the proposed Transfer...Each Tag-Along Member participating in the Tag-Along Sale shall receive the same form and value of consideration to be received by the Initiating Member per Unit.*

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Operating Agreement "Must-Avoid"

- Powers of Management
  - *The term "Power of Management" shall mean the power to manage, supervise and control the Partnership properties and shall mean full power to do all things necessary or helpful in carrying out the purposes of the Partnership; provided, however, those having Powers of Management are subject to the approval rights of the Limited Partners...*

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Operating Agreement "Must-Avoid"

- Distribution of Cash Flow
  - *The Distributable Cash of the Partnership for each fiscal year <u>shall be distributed at least annually</u> within sixty days following that fiscal year to Each Partner Pro Rata.*

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Takeaways

- In determining DLOMS and DLOCS, an appraiser must weigh
  - Empirical benchmarks
  - Judicial precedent
  - Engagement-specific facts & circumstances
  - The governing document
  - Type of asset being appraised
- Before finalizing an agreement, consider asking an appraiser to review it with an eye to discounts

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Questions?

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