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CONTROLLING INTERESTS—DISCOUNT FOR LACK OF MARKETABILITY: PART 2

By Ronald D. DiMattia, CPA, ABV, CMA

My prior article (*CPA Expert*, Summer 2008) analyzed the concept of a discount for lack of marketability[1] for controlling ownership interests in privately held companies. The article analyzed the conceptual basis for such a discount and identified a possible source of empirical data, known as merger arbitrage transactions. As noted in the prior article, merger arbitrage transactions appear to have useful characteristics in assessing the discount for lack of marketability for controlling ownership interests.

In this article, I start with a brief overview of valuation theory as it relates to discounts for lack of marketability for controlling ownership interests. Then I analyze two key arguments against a discount for lack of marketability for controlling ownership interests: Control owners can (1)"put the stock in play" (begin the sale process) at their discretion and sell their ownership position and (2) can dictate the amount and timing of distributions to shareholders, and have the full benefit of cash flows until they sell their ownership position.[2] Analysis of both arguments finds them to be lacking in certain respects. As a result, it appears that a controlling ownership interest in a privately held company is most properly viewed as nonmarketable, and a discount for lack of marketability should be considered in valuing such an interest.

CONTROLLING OWNERSHIP INTERESTS AND VALUATION THEORY

As described in my prior article, some controversy surrounds the idea that a controlling ownership interest is most properly viewed as nonmarketable (or illiquid). The most authoritative argument against the view that controlling interests are nonmarketable is found in the following statements:

> *...The conceptual math for each enterprise level indicates that value is a function of expected cash flow, risk, and expected growth. If an appraiser adequately measures expected cash flow and the risks and growth of those cash flows, the result is an enterprise value.*
>
> *The argument against the existence of a marketability discount applicable to controlling interests is simple. If the enterprise value is determined based*

1 It is becoming more common for valuation analysts to distinguish between marketability and liquidity when analyzing the valuation result for a privately held company. This article, however, will continue with the more generalized use of the term *lack of marketability*, which would include the effect of illiquidity.

2 A third argument against a discount for lack of marketability for controlling interests could be the control owner's ability to cause the company to file for an initial public offering (IPO). Because an IPO is a remote possibility, at best, for most privately held companies, the argument is not analyzed in this article. For more information about the IPO argument, see "The Failed IPO Study: Insight Into the DLOM" by Gregg S. Gaffen, CFA, ASA, of Willamette Management Associates in the February/March 2005 issue of *Focus*, a newsletter of the AICPA Forensic & Valuation Services Section (Vol. 1, No. 2).

on expected cash flows, expected growth of those cash flows, and the riskiness of those cash flows, then what additional factors would support a discount from this value? The Integrated Theory suggests there are none.[3]

The stock market (in its collective wisdom) does the same thing in establishing prices for particular stocks. And for that moment when the stock price is evident, the risk/return characteristics of the stock are properly captured in its price (barring any unusual speculative influence). That is because valuation is a point estimate—an estimate at a given time. Additionally, valuation reflects *foreseeable* expectations of future events—both within and outside the subject company. Changes in price are inevitable over a period of time, because even foreseeable events do not occur exactly as expected.[4] As time goes on, the stock market continually re-evaluates the company, its expected cash flows, risk and expected growth of cash flows, and how these relate to the stock price. Minute-by-minute fluctuations in the stock market reflect these facts.

Therefore, any estimate of value on any given day is subject to risk because expectations of future events underlying the valuation estimate may not be realized. The difficulty arises when a price is accepted and then a lengthy period of time must elapse before that price can be realized in cash. When the time frame to actually realize the quoted value covers a lengthy period, it is reasonable to assume that the potential for significant fluctuations in stock price is meaningful.

The greater difficulty is that *unforeseen* events can occur which would cause the market to take a completely different view of the company, its expected cash flows, risk and expected growth of cash flows, and how these relate to the stock price. Lack of precision in interpreting foreseeable events combined with the potential for unforeseen events cause investors great concern because significant changes in a stock's valuation can result.

As a result, in order for a controlling ownership interest to be viewed as marketable, some important conditions must be met. First, there must be some certainty in actually receiving the quoted value in a timely fashion. Second, in an environment in which receipt of the quoted value is not timely and a stock price (or quoted value) has ample time and potential to vary widely, shareholder distributions must be sufficient to do three things prior to consummating the actual sale:

1. During the period prior to the sale being consummated, distributions must provide an implicit market-based return on the quoted value.
2. If the stock declines prior to the sale being consummated, distributions must provide an implicit market-based return on the quoted value long enough for the stock to rebound and then be liquidated at the quoted value.
3. If the stock does not rebound prior to the sale being consummated, distributions must compensate shareholders for the difference between the actual closing price and the quoted value.

These conditions relate to the two key arguments cited earlier that are often advanced to support the position that controlling ownership interests are marketable. The arguments are analyzed in the following paragraphs.

SALE OF STOCK

It is widely assumed that a controlling owner can put the stock in play, presumably at their discretion, and liquidate their ownership position. But the ability to put a stock in play does not immediately result in cash and is not always successful.

3 Z. Christopher Mercer and Travis W. Harms, *Business Valuation: An Integrated Theory*, Second Edition (New Jersey: John Wiley and Sons), pp. 94-95.

4 A common element in the Statement of Assumptions and Limiting Conditions in many valuation reports is the following: "We do not provide assurance on the achievability of the results forecasted by [ABC Company] because events and circumstances frequently do not occur as expected; differences between actual and expected results may be material; and achievement of the forecasted results is dependent on actions, plans, and assumptions of management." Statement on Standards for Valuation Services No. 1, issued by the AICPA Consulting Services Executive Committee, June 2007, page 37, number 4.

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As demonstrated in my prior article, the time to complete a transaction can be lengthy and the risk of failure is meaningful even for the most marketable entities in America—publicly traded companies.[5]

Empirical data show that from the announcement of a transaction to acquire a publicly traded company until its closing, the time period averages three months or more.[6] Anecdotal evidence indicates that the sale of a privately held company requires 9 to12 months.[7] These periods of time are not inconsequential because during the period any number of events could occur; one being the failure of the transaction.

Empirical data also show that the failure rate of announced acquisitions of publicly traded companies is roughly 20%, and anecdotal evidence indicates that the failure rate is as high as 80% in the sale of privately held companies.[8] In times of economic upheaval (as we find ourselves in currently), a lengthy period between announcement and closing of a transaction heightens the potential for deal failures. For example, several high-profile transactions ended in litigation because the buyer could not justify a price, which subsequent events demonstrated was too high.[9]

Even a cursory review of stock charts shows that any given stock's price can vary widely over a very short time period—even over just a few days' time. As the length of time grows, the opportunity for variation becomes greater. Certainly, stocks can and do go up in price and investors reap the benefit. But because investors are risk averse, they are principally concerned with the risk that the stock price (or quoted value) will decline. Unfortunately, the current market environment amply demonstrates that stocks can experience severe declines. Many publicly traded companies have experienced share price declines of 50% or more during a two to three month period.

So even though a control owner can begin a sale process, it is not likely that they will receive the proceeds in a timely fashion. Furthermore, it is not a certainty that they will realize the quoted value of the stock—the price could be lower, or the deal could fail outright. As a result, an owner's ability to begin a sale process is not sufficient alone to characterize a controlling ownership interest as marketable.

SHAREHOLDER DISTRIBUTIONS

A controlling owner's ability to dictate distributions is the cornerstone of the argument that controlling ownership interests should be considered marketable. But events of the last 18 months clearly indicate that the ability to control distributions is not free from risk. Although extreme, these events are instructive of the types of concerns investors have. A number of large and well-known companies stopped paying dividends, or reduced them dramatically.[10] As recent events have shown, even if a controlling owner desired to make distributions he or she could be precluded from the decision for a variety of reasons including the following:

- Financial markets could shift, causing the firm to retain substantially all of its free cash flow to correct its financial position (as happened recently in the banking sector).
    - It is important to note that the idea of a "credit crunch" is not unique. The U.S economy went through a milder credit crunch in the early 1990s.
- Unexpected operational issues could develop, requiring the company to conserve cash for an extended period (such as a labor strike, several of which occurred in 2006/2007).

It is not a certainty that a controlling owner will always have a certain amount of cash to distribute. Often there are periods when the need to maintain operations will take precedence over the controlling owner's desire to distribute cash. These periods can be quite long. Smaller privately held companies seem to be much more susceptible to variations in distributable cash flow because of inferior access to capital markets and less diverse operations. From a valuation perspective this is critical, because without the certainty of receiving cash on a regular basis investors are subjected to additional risk from which they seek protection.

The close link between value and cash flow is also problematic for supporting the idea that controlling ownership interests are marketable. When a company's stock price falls from the quoted value prior to being sold, the reason is often that expectations of future cash flows have been compromised in some respect. Certainly macroeconomic or deal-specific issues could have an effect, but even these would often have some impact on expectations of the company's future cash flows. In an environment of a lower share price and potentially compromised cash flows, is it reasonable to assume

5 Ronald D. DiMattia, "Controlling Interests — Discount for Lack of Marketability: The Empirical Evidence," *CPA Expert*, Summer 2008, pp. 1-6.
6 DiMattia, p. 4.
7 DiMattia, p. 3.
8 DiMattia, pp. 3-5.
9 Examples include the Dow Chemical/Rohm & Haas transaction (which litigation settled as this article was being written) and the Huntsman/Hexion transaction.
10 Examples include Alcoa, Capital One, CBS Corp., Cedar Fair, Wells Fargo, US Bancorp, PNC, J.P. Morgan Chase and General Electric, among others.

that the control owner can create a market-based return on the quoted value until the stock rebounds? Is it reasonable to assume that the control owner could distribute enough cash to make up for the difference in valuation if the stock does not rebound? Perhaps, on both counts, but it would depend on how far the stock has fallen, how deeply the cash flows have been compromised, how likely the price is to rebound, and the time frame of the hoped-for rebound. Given a large enough correction in the stock price or distributable cash flows, one is hard pressed to imagine a scenario that could work.

Practical concerns also present problems for the argument that a control owner can dictate the amount and timing of distributions prior to a sale being consummated. Generally, controlling ownership interests are sold pursuant to the terms of a letter of intent; the terms are formalized and finalized in a purchase agreement. Most terms of a letter of intent are nonbinding, but the letter does set forth each party's expectations about basic elements of the final purchase agreement, the conduct of the parties prior to closing, and the ability of either party to terminate negotiations. Many of these agreements set forth an expectation that the owner will not distribute cash outside the normal course of business prior to the transaction closing. Additionally, purchase agreements often contain a formal representation that the seller has not made any distributions outside the normal course of business in the period prior to the transaction closing.

Interim cash flows that a control owner can direct to shareholders would certainly be a risk or contingency that a valuation analyst must consider in assessing a discount for lack of marketability. But the opportunity for it is not so complete and determinative as to negate the consideration of a discount for lack of marketability. Practical matters, risks and contingencies associated with future cash flows as a support for marketability are too great to ignore.

CONCLUSION

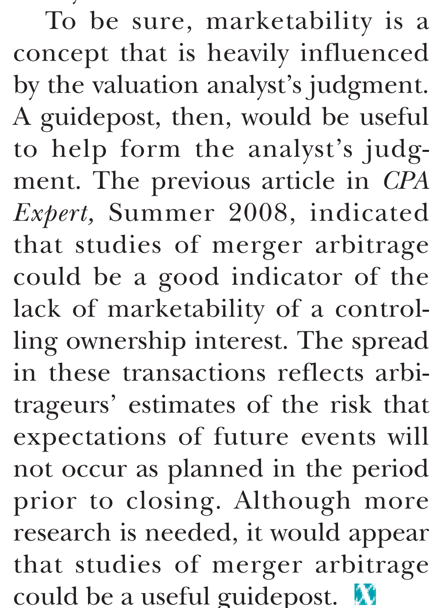
This article demonstrates that, from both a theoretical and practical standpoint, controlling ownership interests in privately held companies are most properly viewed as nonmarketable. Given that selling a controlling ownership interest is not an immediate event, risk in actually realizing the quoted valuation is substantial. Investors are not capable of perfect foresight, and as time progresses one would expect investors to re-evaluate the basis of their valuation. More troubling is the emergence of unforeseen events, which can have a significant impact on an investors' valuation. Therefore, the argument that controlling interests are marketable relies on the owner's ability to 1) put the stock in play and 2) direct distributions to shareholders.

However, an owner's ability to put the stock in play is not sufficient to characterize a controlling ownership interest as marketable. Empirical evidence indicates that the time to realize the quoted value in cash is lengthy and the risk of deal failure is meaningful. Stock market data also indicate that the potential for a significant fall-off in valuation during the period prior to a transaction being consummated is meaningful.

Similarly, an owners' ability to direct distributions to shareholders is not sufficient to characterize a controlling ownership interest as marketable. It is not a certainty that a controlling owner will have sufficient cash available to make distributions to shareholders. Additionally, from a practical perspective a control owner's ability to make distributions often is severely restricted during the period prior to a transaction being consummated.

Because investors are risk averse, they are concerned with the potential for a price decline from the point of the quoted value to the point it is realized as cash. Our attempt, then, is to measure how much protection an investor will require to accept a point estimate of value, knowing that it will not be realized until a meaningful period of time has elapsed. Offsetting this risk would be the interim cash flows that can be distributed. Even so, meaningful risks exist for the controlling owner, and it is logical to expect that a rational investor would seek protection from such risks. The expected form of such protection would be a discount to reflect the relative lack of marketability.

To be sure, marketability is a concept that is heavily influenced by the valuation analyst's judgment. A guidepost, then, would be useful to help form the analyst's judgment. The previous article in *CPA Expert,* Summer 2008, indicated that studies of merger arbitrage could be a good indicator of the lack of marketability of a controlling ownership interest. The spread in these transactions reflects arbitrageurs' estimates of the risk that expectations of future events will not occur as planned in the period prior to closing. Although more research is needed, it would appear that studies of merger arbitrage could be a useful guidepost.



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