Marketability, Liquidity, and Controlling Equity Interest

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Here's the controversy: Do controlling equity interests in business entities merit consideration of discounts for lack of marketability or lack of liquidity?

The logic of incorporating such discounts in determining the value of noncontrolling/minority interests is well set in generally accepted valuation precedent. Furthermore, the use of marketability and/or liquidity discounts in valuing these equity interests is backed by a variety of third-party empirical studies providing significant evidence of the economic reality associated with the inability to easily convert these interests into cash.

Such is not the case with the valuation of controlling equity interests. There is no dominating, broadly accepted precedent within the profession. There is no third-party evidence, such as the studies noted above that support such discounts for minority interests, available to validate the use of such discounts in the valuation of controlling equity interests. Thus, the use of discounts for lack of marketability or liquidity in valuing controlling equity interests continues to be an area of interest and varying treatment within the profession.

Historically, all issues related to the discount for lack of marketability were focused on a comparison to perfect marketability. In effect, the standard of perfect marketability was associated with equity interest traded on the major stock exchanges. Members of the profession were taught that the ability to easily and quickly convert the economic value of the subject equity interest to cash via a sale of publicly traded shares on the open public stock markets reflected that perfect marketability. In fact, the *International Glossary of Business Valuation Terms* defines the term *marketability* as "the ability to quickly convert property to cash at minimal cost."[1]

The standard of perfect marketability was easy to contrast to equity interests in privately held business enterprises. In these entities, no "ready market" exists for the immediate conversion of these interests into cash at a minimal cost. Indeed, many shareholder, partnership, and operating agreements, which are drafted to accomplish other business purposes, include provisions restricting transfers of equity interests. In these instances, not only does the lack of a ready market influence consideration of such discounts, but the presence of restrictive provisions in the governing agreements also exacerbates the risk associated with the inability to quickly convert the value of that interest to cash.

Over time it has become evident that marketability differs from liquidity. Once used interchangeably, practitioners have now come to realize that the two attributes, while interrelated, are somewhat different. Perhaps the best description of how the two attributes differ is in the *Discount for Lack of Marketability Job Aid for IRS Valuation Professionals.*[2] While the terms *marketability* and *liquidity* are defined in the *Job Aid* by reference to the *International Glossary*, the concepts are not sufficiently differentiated within that *Glossary*. Similar to the definition of marketability, as set forth above, the *Glossary* defines *liquidity* as "the ability to quickly convert property to cash or pay a liability." Under this definition, the similarity of liquidity to marketability is readily apparent.

In the *Job Aid*, the authors provide a useful distinction between the two terms. The *Job Aid* notes that *marketability* indicates the fact of "saleability," while *liquidity* shows how fast that sale can occur at the current price.

This distinction should not be dismissed in the consideration of discounts for lack of marketability/liquidity for controlling equity interests. The distinction is critical to the argument defending some valuation adjustments related to those economic risks associated with a lack of marketability or liquidity attendant to a controlling equity interest.

To further define the distinction, the *Job Aid* goes on to spell out three fundamental premises related to the interrelationship between the two terms:

- If it's (the equity interest) liquid, it's marketable
- If it's non-marketable, it's illiquid
- Being illiquid does not necessarily mean non-marketable – it may still be sellable but not quickly or without loss of value[3]

If one is to accept these fundamental premises, in effect, *marketability* does not require *liquidity.* If that derivative premise is to be accepted, then it stands to reason that, in most circumstances, liquidity is an element of marketability. A marketable equity interest is either able to be converted to cash

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The *IRS DLOM Job Aid* provides a useful distinction between the terms *marketability* and *liquidity.*

quickly or it is not. Such an understanding would seem to provide a sound basis for considering a valuation discount of some order in valuing controlling equity interests.

The arguments against the use of discounts for lack of marketability in valuing these interests have historically focused on the element of control itself, with the leading point being the controlling equity interest holder's capability to initiate and facilitate a sale of the interest (as well as the company). In addition, many restrictions imposed upon equity interest holders in the company's governing agreements and documents are easily modified, as needed. As such, these limiting restrictions on the holders of the controlling interests have a lesser degree of investment risk, thereby warranting a lower discount or none at all.

Dr. Pratt notes in *Valuing a Business* that certain factors require consideration in assessing the need to include a discount of some type related to marketability/liquidity. These include:

- An uncertain time horizon in which the sale of the equity interest could be completed and accomplished
- The use of entity-level cash flows for accounting, legal, and other costs to prepare and execute the sale of the controlling interest or business
- The investment risk associated with the eventual sales price
- The investment risk associated with the receipt of "non-cash" purchase price consideration and deferred transaction consideration
- The investment risk associated with the inability to hypothecate

To be sure, each of these factors represents a true economic risk that the holder of the interest must consider in dealing with transactions in that security. In addition, many commentators and business valuators include potential brokerage fees within the risks inherent in the second factor, noted above. Transaction structure, such as an asset deal versus a stock deal, also affects realization of potential net deal proceeds and is often considered under the fourth factor, noted above. These core factors have long been considered and used as a basis for defending discounts for lack of marketability as they relate to valuations of controlling equity interests.

Whether these items are associated with the term marketability or liquidity is not often addressed. A closer look at each of the factors would seem to indicate that they are more closely aligned with idea of liquidity— as that term is defined in the *Job Aid* and numerous treatises— than with marketability.

If one thinks of investment risk in light of holding periods and potential fluctuations in value that can occur over that period, it becomes incumbent on the holder (or valuator) to put bookends on the holding period. In other words, it is clear that measurement of risk over a specific holding period, actual or estimated, requires an equity-interest acquisition date and a disposition date. In the context of valuation, and consideration of discounts related to marketability or liquidity, the deemed acquisition date is simply the date of valuation. The disposition date, of course, relates to the date that the transaction is scheduled to close and when proceeds are dispersed. At all points in between these two bookends in the holding period, the value of the equity interest is at risk.

The presumption in assessing this time-horizon risk must, out of necessity, assume that the equity interest is marketable. If such were not the case, there could be no identified holding period. Thus, by simple logic, the consideration of a discount for lack of marketability or liquidity could be argued to be wholly liquidity-oriented. The time-horizon risk envisioned by the first factor noted in Pratt's treatise readily encapsulates the risk of receiving the expected sales price at the end of the holding period when the transaction is closed. In addition, the risk associated with the inability to hypothecate simply expires at the end of the holding period, as proceeds are realized. While generally argued as supporting points in defense of discounts for lack of marketability, these two points are integrated in the valuator's assessment of the risk associated with the uncertain time horizon. As such, they also appear to support consideration of a discount for lack of liquidity, versus a discount for lack of marketability.

The final two factors – the use of entity-level cash flows for accounting, legal, and other costs to prepare and execute the sale of the controlling interest or business, and the investment risk associated with the receipt of "non-cash" purchase-price consideration and deferred-transaction consideration– clearly arise only if the holder of the equity interest elects to enter into a potential sale transaction. Such circumstances clearly infer that the attribute of marketability is present, as no prudent investor or holder of that equity interest would incur these risks without that presumption.

As a result, it would appear that controlling interest valuations would more often require a discount for lack of liquidity as opposed to a discount for lack of marketability. As lack of marketability conveys a greater investment risk, it stands to reason that any discount determined to provide a valuation adjustment for a lack of liquidity would be substantially lower than a discount for lack of marketability. Language in the *Job Aid* further supports this position, noting that being illiquid does not equate to a finding that the subject equity interest is not marketable. As such, it seems reasonable to conclude that liquidity is an element of overall marketability, and a lack of liquidity presents lesser risk than a lack of marketability. ∞

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1 *International Glossary of Business Valuation Terms*, 2001, as adopted by the AICPA, ASA, CICBA, NACVA and IBA.

2 *Discount for Lack of Marketability Job Aid for IRS Valuation Professionals*, Sept. 25, 2009.

3 *International Glossary of Business Valuation Terms,* 2001

4 *Discount for Lack of Marketability Job Aid for IRS Valuation Professionals*, Sept. 25, 2009.

5 Ibid.

6 Pratt, Shannon P. and Alina V. Niculita, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies,* 5th ed. (New York: McGraw-Hill, 2008). p. 441.