



GROSSMAN YANAK & FORD LLP
Certified Public Accountants and Consultants

Business Valuation: Valuation Discounts & Current Perspectives



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Business Valuation: Valuation Discounts & Current Perspectives

INTRODUCTION



Understanding Valuation Discounts & Current Perspectives

INTRODUCTION

- ***Basis of application***
 - The use of discounts and/or premiums in conjunction with a business valuation conclusion is not a matter of law, but rather a matter of fact.



Understanding Valuation Discounts & Current Perspectives

INTRODUCTION

- ***Burden of proof***
 - The burden of proving the propriety of discounts and/or premiums utilized falls, ultimately, to the business valuator
 - The most common basis for not successfully defending discount level challenges is the failure to properly reconcile the subject equity interest characteristics with third party inferential observations



Understanding Valuation Discounts & Current Perspectives

INTRODUCTION

- ***The essence of business valuation***
 - Not an exact science
 - Result of four interrelated concepts
 - Consideration of relevant facts
 - Use of common sense
 - Informed professional judgment
 - Reasoned assessment



Business Valuation: Valuation Discounts & Current Perspectives

FUNDAMENTAL CONCEPTS



Understanding Valuation Discounts & Current Perspectives

FUNDAMENTAL CONCEPTS

- ***Standards of Value***
 - Fair Market Value
 - Hypothetical sales price
 - Willing buyer/seller
 - No compulsion
 - Fully knowledgeable
 - Both parties able to trade



Understanding Valuation Discounts & Current Perspectives

FUNDAMENTAL CONCEPTS

- ***Standards of Value***
 - Fair Value
 - Generally court-defined
 - Varies by jurisdiction
 - Protects minority-interest holders
 - Discount applications vary



Understanding Valuation Discounts & Current Perspectives

FUNDAMENTAL CONCEPTS

- ***Standards of Value***
 - Investment Value
 - Specific buyer
 - Incorporates synergistic opportunities
 - Discount applications vary in accordance with transaction interpretations
 - Often, transaction economics include valuation adjustments



Understanding Valuation Discounts & Current Perspectives

FUNDAMENTAL CONCEPTS

- ***General considerations for discounts and premiums***
 - Fair market value set by market
 - Investors are risk adverse
 - Base of application must be defined
 - No “prescribed” ranges of discounts/premiums
 - Discount for lack of control & discount for lack of marketability are separate and distinct
 - DLOC & DLOM are multiplicative, NOT additive



Understanding Valuation Discounts & Current Perspectives

FUNDAMENTAL CONCEPTS

- ***Factors that influence applicability***
 - Purpose of the valuation – divorce, estate, ESOP, etc.
 - Attendant rights and characteristics of ownership interest being valued – ownership restrictions or put option
 - Ownership structure of the entity being valued – voting vs. non-voting shares
 - Quality of management team – thin management, strained family relationships



Understanding Valuation Discounts & Current Perspectives

FUNDAMENTAL CONCEPTS

- ***Factors that influence applicability***

- Size of company – small “Mom and Pop” vs. large multifaceted business
- Size of block of stock – swing vote consideration
- Propriety of management salaries, prerequisites, etc. – excess compensation and/or benefits out of the control of a minority shareholder



Understanding Valuation Discounts & Current Perspectives

FUNDAMENTAL CONCEPTS

- ***Factors that influence applicability***

- Stock-related issues – dividend policy and history, stock redemption policies, restrictions on stock sales, right of first refusal, etc.
- Financial condition of the subject company and volatility of earnings – bank restrictions on dividends, etc.
- Federal and state regulatory restrictions, including Treasury regulations regarding estates/gifts and Department of Labor rules regarding ESOPs



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FUNDAMENTAL CONCEPTS

- **Factors that influence applicability**
 - State corporation statutes – NY/IL supermajority
 - Market desirability – struggling vs. thriving industry
 - Potential synergies, if any, with potential buyer(s)
 - Investment time horizon



Understanding Valuation Discounts & Current Perspectives

FUNDAMENTAL CONCEPTS

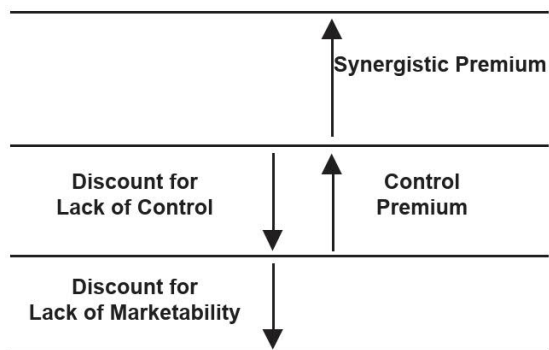
- **Levels of Value**

Control, Marketable Value
(on an investment or a synergistic value basis)

Control, Marketable Value
(on an FMV basis)

Minority, Marketable Value

Minority, Non-marketable Value





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CONTROL PREMIUMS & MINORITY DISCOUNTS



Understanding Valuation Discounts & Current Perspectives

CONTROL PREMIUMS AND MINORITY DISCOUNTS

- ***Advantages of control***
 - Set company policy and influence operations
 - Appoint management
 - Acquire and dispose of assets
 - Select vendors/suppliers



Understanding Valuation Discounts & Current Perspectives

CONTROL PREMIUMS AND MINORITY DISCOUNTS

- *Advantages of control*
 - Facilitate business reorganizations
 - Business acquisitions/dispositions
 - Corporate liquidations
 - Recapitalizations
 - Initial public offerings
 - Sell or acquire treasury shares



Understanding Valuation Discounts & Current Perspectives

CONTROL PREMIUMS AND MINORITY DISCOUNTS

- *Advantages of control*
 - Dictate dividend policy and payments
 - Revise organization documents
 - Establish or revise buy/sell agreements
 - Effectively “block” any of the above actions



Understanding Valuation Discounts & Current Perspectives

CONTROL PREMIUMS AND MINORITY DISCOUNTS

- *Assessing levels of control*
 - Board of Directors representation
 - Direct representation
 - Indirect representation via cumulative voting rights



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CONTROL PREMIUMS AND MINORITY DISCOUNTS

- *Assessing levels of control*
 - Contractual restrictions
 - Loan agreements with restrictive covenants
 - Other agreements
 - Organization agreements
 - Shareholder agreements
 - Buy/sell agreements



Understanding Valuation Discounts & Current Perspectives

CONTROL PREMIUMS AND MINORITY DISCOUNTS

- *Assessing levels of control*
 - Industry regulations
 - State corporate and entity laws
 - Voting rights
 - Financial condition of business
 - Size of block of stock
 - Concentration of ownership



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CONTROL PREMIUMS AND MINORITY DISCOUNTS

- *Valuation Platforms*
 - Control vs. Minority platform
 - Depends on the numerator
 - Most, if not all, of the difference in minority or control freely-traded value as a platform rests with whether the future benefit stream has been adjusted for control perquisites



Understanding Valuation Discounts & Current Perspectives

CONTROL PREMIUMS AND MINORITY DISCOUNTS

- *Valuation Platforms*
 - Income Approach
 - Capitalized returns
 - Discounted future returns
 - Minority or control freely-traded value



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CONTROL PREMIUMS AND MINORITY DISCOUNTS

- *Valuation Platforms Example (Control vs. Minority)*

	<u>Control</u>	<u>Minority</u>
Benefit Stream (numerator)	1,000	700
Capitalization Rate (denominator)	<u>.20</u>	<u>.20</u>
Value	<u>5,000</u>	<u>3,500</u>
	1,500	
	Discount 30%	



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CONTROL PREMIUMS AND MINORITY DISCOUNTS

▪ *Valuation Platforms*

- Market Approach
 - Guideline company method: minority/control freely-traded value
 - Merger and acquisition method: control marketable value



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CONTROL PREMIUMS AND MINORITY DISCOUNTS

▪ *Valuation Platforms*

- Asset-Based Approach
 - Net asset value method
 - Excess earnings method
 - Control marketable value



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CONTROL PREMIUMS AND MINORITY DISCOUNTS

- *Measuring minority interests*
 - Three general methodologies
 - Horizontal method
 - Top-down method
 - Bottom-up method



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CONTROL PREMIUMS AND MINORITY DISCOUNTS

CONTROL

- 100% Equity Ownership Position
- Control Interest with Liquidating Control
- 51% Operating Control
- Two equity holders, each with 50% interest
- Minority with largest block of equity interest
- Minority with “swing vote” attributes
- Minority with “cumulative voting” rights
- Pure minority interest – no control features

MINORITY



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IRS POSITION ON FAMILY ATTRIBUTION

▪ *Revenue Ruling 93-12*

- Replaces Revenue Ruling 81-253
- Represents IRS acquiescence on numerous cases
- Provides taxpayer with an opening to apply a discount for lack of control (minority) in family-related stock ownership situations
- Does NOT guarantee a discount



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IRS POSITION ON FAMILY ATTRIBUTION

▪ *“Swing vote” qualities*

- TAM 9436005 & TAM 9449001
 - Consider element of value attributable to joining two blocks of ownership together to attain a different level of control
 - Recognize that, for gift tax purposes, value is determined with regard to donee (minority) rather than donor (majority)
- Swing Vote premium will almost always be smaller than the minority interest discount



Business Valuation: Valuation Discounts & Current Perspectives

LACK OF MARKETABILITY (LIQUIDITY) DISCOUNTS



Understanding Valuation Discounts & Current Perspectives

LACK OF MARKETABILITY (LIQUIDITY) DISCOUNTS

- *Definition of marketability*

- 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



Understanding Valuation Discounts & Current Perspectives

LACK OF MARKETABILITY (LIQUIDITY) DISCOUNTS

▪ *Theoretical support for use of discount*

- Risks associated with potential sale of interest
 - Uncertain time horizon to complete the offering or sale
 - Cost to prepare for and execute the offering or sale
 - Risk as to eventual sale price
 - Non-cash and deferred transaction proceeds
 - Inability to hypothecate (or inability to borrow against the estimated value of stock)



Understanding Valuation Discounts & Current Perspectives

LACK OF MARKETABILITY (LIQUIDITY) DISCOUNTS

▪ *Factors that increase discounts*

- Restrictions on transfers of stock
- Little or no dividends or partnership pay-out
- Little or no prospect of either a public offering or sale of the company
- Limited access to financial information



Understanding Valuation Discounts & Current Perspectives

LACK OF MARKETABILITY (LIQUIDITY) DISCOUNTS

- *Factors that decrease discounts*
 - Presence of “put” options
 - Presence of a limited market (i.e. ESOP)
 - Imminent IPO or company sale
 - High cash pay-out history



Understanding Valuation Discounts & Current Perspectives

LACK OF MARKETABILITY (LIQUIDITY) DISCOUNTS

- *Factors that increase or decrease discounts*
 - Size of block (depends on size and facts)
 - Presence of a buy/sell agreement



Business Valuation: Valuation Discounts & Current Perspectives

EMPIRICAL STUDIES



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EMPIRICAL STUDIES

- *Restricted Stock Studies*
- *Initial Public Offering (IPO) Studies*
- *Summary of Results of Various Studies:*
 - Restricted stock studies – Range From 10%-90% with averages ranging from 25%-45%
 - IPO studies – Range Approximately 43%-54%

THERE ARE NO PROXY LEVELS!



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EMPIRICAL STUDIES

▪ *Observations and conclusions*

- The smaller the company (revenues, earnings, market capitalization), the larger the DLOM
- Issuers of restricted stock are generally considered good credit risks and have an active market for their stock – not true of a closely held business
- Owners of stock in a closely held business have no access to an active market for their stock



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EMPIRICAL STUDIES

▪ *Observations and conclusions*

- Publicly traded companies offer annual dividends and/or established record of capital appreciation in share price – closely held businesses seldom offer either
- Institutional investors purchase restricted stock with investment goals and criteria which is far different from the individual purchaser of a closely held business



Understanding Valuation Discounts & Current Perspectives

EMPIRICAL STUDIES

▪ *Observations and conclusions*

- Purchasers of restricted securities have different levels of risk perception and risk tolerance than purchasers of closely held businesses
- Purchasers of restricted securities understand that a ready market will exist for the securities; purchasers of closely held business stock have little or no expectation of such a market



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EMPIRICAL STUDIES

▪ *Observations and conclusions*

- Use of discounts from restricted stock studies infer that publicly traded issuers of restricted stock are “comparable” to closely held business, which may not be the case
- Blind reliance on empirical studies or discounts allowed by the courts in other cases is dangerous, as each valuation has its own unique facts



Understanding Valuation Discounts & Current Perspectives

EMPIRICAL STUDIES

- *Observations and conclusions*
 - Valuation analysts who rely solely upon empirical studies often understate discounts and overstate value
 - Valuation analysts often fail to adequately support specific discounts with sound reasoning
 - Regardless of method used, an intimate knowledge of the study and relationship of specific attributes to the subject company is crucial



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MANDELBAUM DECISION





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MANDELBAUM DECISION

▪ *9 factors considered*

1. Financial statement analysis
2. Dividend policy
3. Nature of the company, its history, position in the industry, and its economic outlook
4. Management



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MANDELBAUM DECISION

▪ *9 factors considered*

5. Amount of control in the transferred shares
6. Restrictions on transferability of the stock
7. Holding period for the stock
8. Company's redemption policy
9. Costs associated with a public offering



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CURRENT ISSUES



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CURRENT ISSUES

- *COVID impact on marketability of a business*
- *Decreased number of transactions reported to valuation databases – does this infer less marketability of privately held businesses?*



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CURRENT ISSUES

- *Adjustments must be made to base discounts determined through empirical data*
- *Specific company factors must be considered in determining level of discounts and adjustments to base discounts*



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CONCLUSION & PRACTICAL CONSIDERATIONS





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CONCLUSION AND PRACTICAL CONSIDERATIONS

- *Valuation discounts are a result of two factors*
 - The characteristics of the subject interest under consideration
 - The purpose and standard of value associated with the attendant valuation analysis
- *Empirical data provides a starting point for quantifying valuation discounts*



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CONCLUSION AND PRACTICAL CONSIDERATIONS

- *Due care must be taken to assure the magnitude of valuation discounts is appropriate*
- *Adjustments to base discounts must be made in consideration of Date of Valuation specific issues including COVID-related issues and the impact of changes to tax laws and regulations*