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The Controversy over the Discount for Lack of Marketability

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It is easy to sell your shares of Microsoft stock. You call your broker or access the Internet, the trade occurs almost instantaneously, and you receive your money in three business days or less. Your Microsoft shares are "fully liquid" because they can be readily converted to cash.

Interests in private businesses, however, are much less liquid because there is no ready market (willing buyer) for them. They require many months to sell - if they can be sold at all - because they must be prepared for sale, financial and other documentation must be assembled, intermediaries must be engaged, qualified buyers must be found, and sales must be negotiated and closed. Such interests are "illiquid" as a result, and their values must be reduced ("discounted") to reflect their lack of marketability.

The discount for lack of marketability ("DLOM") is often the single largest value adjustment business appraisers must consider. It can exceed 30% in many cases. However, there is no perfect way to measure it, and there are disagreements over its causes. As a result, the Internal Revenue Service, the Tax Court, other courts across the nation, regulatory agencies (the Securities and Exchange Commission, the Financial Accounting Standards Board, and the Department of Labor, among others), academicians, compilers of market data, and business appraisers have given considerable attention to the DLOM.

ABA National Network members, by virtue of their extensive experience, training, and certifications in business valuation, have appraised DLOMs and successfully defended their conclusions in thousands of engagements. We believe that the DLOM controversy, in the final analysis, can be distilled to two fundamental questions:

1. What does it include?
2. How can it be measured?

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Components of the DLOM

The voluminous professional, academic, and legal literature and our frequent discussions with colleagues suggest that the DLOM has five potential components:

1. One-time transaction costs.

Sellers of private businesses must pay legal, accounting, and brokerage fees, among others. These can be material, particularly for small businesses, as the typical brokerage commission is 10% of the selling price.

We believe that transaction costs do not contribute to the DLOM for both practical and theoretical reasons. In the real world, items are priced separately from the cost of acquiring them. Homes, publicly traded stocks, and bonds are listed at asking prices excluding brokerage and other costs. In fact, almost everything priced for sale is quoted before these costs. (Sometimes sales and excise taxes are included but they are separately disclosed.) From a theoretical standpoint, no appraisal methodologies or market data make allowances for these one-time costs. The values they produce exclude them.

Transaction costs do not cause the DLOM. They are real and sometimes material, but they do not create illiquidity. They are a cost of remedying it.

2. The time value of money.

It may take months or years to sell an entire private business, and it is almost impossible to sell a minority (less than 50%) interest. Most brokers will not list minority interests because of this.

The time value of money is a real and logical cause of illiquidity. If one could earn 10% from another investment, but must hold an illiquid investment instead, the annual opportunity cost of not being able to sell is 10% (compounded).

3. Risk and return.

The time value of money leads to the rate of return an investor earns from a private company investment and the risks of owning it. A critical point is that minority shareholders have different risk and return expectations than do controlling (or sole) shareholders. Considerations such as whether dividends are paid, how retained earnings are reinvested, and how long the interest will be owned, among others, influence the risk / return profile and have a significant impact on liquidity. All other things being equal, for example, investors would prefer to own a security paying annual dividends rather than one that does not: dividends reduce illiquidity (the DLOM) and increase value.

4. Multiple shareholder complexities.

Many considerations fall under this category, but all share a common trait: it is more attractive to be a sole shareholder than to have partners, even if one has control (more than 50% ownership). Shareholder disputes can be costly and time-consuming, and their potential detracts from the marketability of partial interests.

Most of this effect should be accounted for as a value reduction due to lack of control (a topic not discussed in this paper), not lack of marketability. Although the presence of other shareholders arguably reduces the salability of any interest, regardless of size, we believe that this effect is usually small relative to those mentioned above.

5. Case facts and circumstances.

Myriad other factors can cause the DLOM. A classic example is a business that discovers an unremediated environmental problem on its real estate. Because the potential liability is unlimited, the equity in this business will be unsalable. No rational buyer would assume a potentially infinite liability. The value of the business is $0: it has a 100% DLOM!

Employee Stock Ownership Plan (ESOP) valuations are legally required each year under ERISA law. Many ABA members value ESOPs, which have "put" options requiring the issuing company to repurchase the shares of a departing employee. If the issuing company has sufficient financial resources (earning power, assets, and unused debt capacity) to honor all reasonably foreseeable (based on actuarial projections) redemptions, there is no objective basis for a DLOM for such shares. (Some practitioners apply a DLOM of no more than 5% for unforeseen circumstances.)

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In summary, the DLOM reflects the absence of a ready market for private equity. The costs to remedy it do not create the DLOM, and are not part of it. The time value of money, differing cash flow and risk expectations between the company and its shareholders, and case-specific factors cause the DLOM and must be carefully researched, analyzed and documented in a business appraisal.

Measurement of the DLOM

There is a major debate within the business valuation community as to how to do this.

Historically, the DLOM was measured using comparable transactions based on the "Market Approach" to appraisal. The most common method, "benchmarking," is based on studies of securities that were sold both with and without liquidity impairments. Two sets of such studies have been made. The first compared restricted (or "letter") stock prices to those of the same issuers which were not restricted. (Restricted stock, often issued in acquisitions or to executives, is identical to freely traded stock except that it cannot be sold on the open market for a given period, now usually one year. It is restricted to prevent massive sales that might depress market prices.) The second compared private placement prices (private sales of equity) to IPO (initial public offering) prices of the same companies.

Many have challenged the benchmarking methodology, citing (1) imperfections in the studies' data; (2) the inappropriate use of study averages that are not adjusted to the facts and circumstances of a case; (3) and its inability to handle special situations (such as when a company is expected to enjoy a major liquidity event, such as its sale). A landmark Tax Court case requires that business appraisers consider a range of case-specific factors when determining the DLOM.

ABA members are well versed in benchmarking, and have used it successfully in thousands of engagements. Nevertheless, we find that one of its principal difficulties is that it does not allow the appraiser to focus on a major cause of illiquidity – the time value of money mentioned above. The length of time an interest is to be owned is a significant cause of illiquidity. There is a big difference between being illiquid (forgoing cash and alternative investment returns) for 1, 5, 10, or 25 years, yet benchmarking does not allow for this consideration.

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Important, pioneering work by Z. Christopher Mercer, ASA, CFA, an ABA friend and colleague, led to his creation of the Quantitative Marketability Discount Model (QMDM), a methodology that measures the DLOM based on fundamental assumptions concerning, among other things, how long a security is owned, risk / return profiles, growth rates, and other case-specific factors.

Although many have questioned the QMDM, no one has found a flaw in its explicit logic. The difficulty in using the QMDM arises in specifying some of its assumptions, for which small changes can lead to large changes in the DLOM.

We view the QMDM's sensitivity not as a flaw, but rather as a major strength. The DLOM is indeed sensitive to its assumptions, and the QMDM is intellectually honest and rigorous in addressing them. In many ways, the QMDM resembles a chain saw: a very powerful tool that must be used proficiently and with great care: i.e. by a highly qualified, experienced appraiser.

In many respects, the debate between benchmarking and the QMDM resembles the classic securities analysts' debate about technical versus fundamental analysis. Technicians rely on market data (price and volume trends) while fundamentalists research company financial, operating and environmental data. Both methods have strengths and weaknesses and are generally accepted in the financial community.

ABA's practical philosophy, based on decades of experience and training, is to use all the tools we can to develop, crosscheck and strongly support our value conclusions. To that end, we must be expert in every method, its application, strengths, and weaknesses. Such expertise is the hallmark of every ABA member.