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## **An Appraiser's Updates on Adjustments for Lack of Control and Lack of Marketability**

**PROJECT 419**

THE **EVENT** FOR ESTATE AND FINANCIAL PLANNERS

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# Why are we here for Project 419?

- //// In some estates, the family business is the largest asset or it has the most potential for highest growth in value.
  
- //// A minority block interest in the family biz may be least liquid asset in estate.
  
- //// Transfer at discount and before it grows in value?
  
- //// What if a high net worth owner waits too long and an estate tax becomes due?
  - Your role is to help preserve the wealthy family's assets
  - The government isn't family (or a charity)
  - Right now, a variety of laws and factors may help a wealthy business owner



# Using Peak Lifetime Exemption

- //// Lifetime exemption amount is ~\$14 million until the end of this year.
- //// Some of that amount is likely to be unavailable after the sunset or a law change.
- //// Isn't it like leaving up to 1/3 of up to \$7 million of taxable value on the table?
- //// Does wealthy owner really still need that much income-producing property?

# Current Economic Conditions

- //// All else being equal, value of an interest in a business goes down in times of economic uncertainty and volatility.
  
- //// Legitimate justification of a lower value from:
  - Uncertainty of future earnings amounts = lower amounts
  - Higher volatility and risk environment = lower earnings multiples
  - Expecting longer holding periods = higher discounts of value too
  - Each contribute to lower value now, so transfer more shares/units using lower value/unit
  
- //// You and client can plan and maintain their control over voting, management policy, and how to maintain their income and lifestyle needs.

# Purpose for Appraisal

- //// There's a vast pool of advisors that will estimate an asking price for a business and market it.
  
- //// There's a separate pool of advisors that will seek to understand:
  - Your client's wealth preservation strategy,
  - Succession and transfer plan and
  - Use plan, restrictive transfer agreement, etc. to properly adjust the value downwards.
  
- //// This separate pool is a specialized area and the body of knowledge and tools to properly support adjustments or discounts of value has changed.



# What Have You Seen?

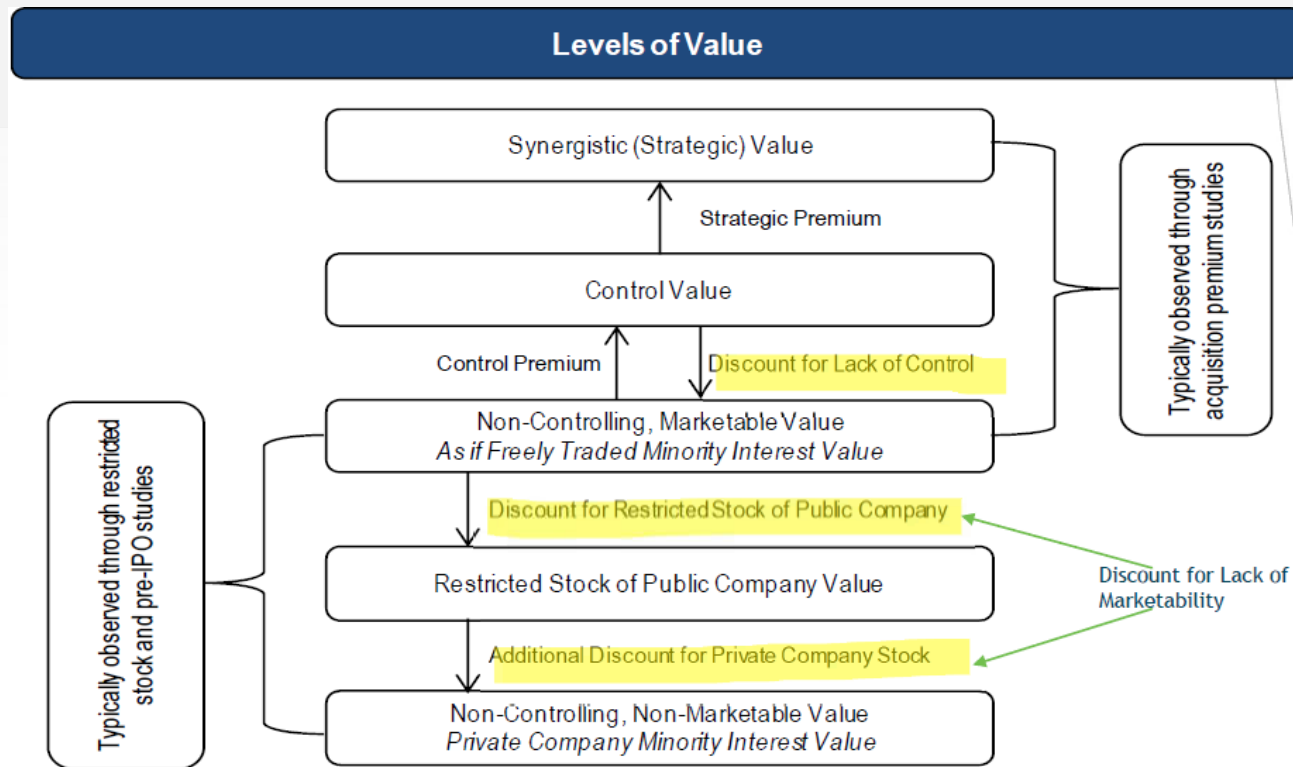
- //// Have you seen appraisal reports with 30+ pages for the pre-discount value?
- //// And then just 3 to 5 pages using boilerplate studies and typical restrictions to justify subtracting 40% of the pre-discount value?
- //// Or 3 paragraphs referring to boilerplate Exhibits attached after the report?
- //// Did anyone question the report? Or parts of it? (After today, you might)
- //// Guess which pages of the report the IRS valuation engineer will attack?

# Levels of Value

//// I normally include in a report that there are levels of value:

- Levels associated with the amount of control or influence of a specific ownership interest.
- *Strategic Control Value* – Value to a particular or strategic buyer --the highest value for an interest.
- *Financial Control Value* - Value of the company as whole without premiums from strategic buyers.
- *Marketable Minority Value* - Value of an ownership interest that lacks control but has the benefit of an active market in which the interest can be freely traded, thus providing liquidity.
- *Nonmarketable Minority Value* - Value of an ownership interest that lacks control and does not have the benefit of an active market in which the interest can be freely traded, thus resulting in a lack of marketability to some degree – the lowest value for any given ownership interest.

# Levels of Value (cont.)



The levels of value chart was based upon data obtained from two sources: a) "Financial Valuation - Applications and Models", Second Edition, James R. Hitchner, John Wiley & Sons, Inc. - New Jersey, 2006, page 377 and b) Valuing a Business - The Analysis and Appraisal of Closely Held Companies, Shannon P. Pratt and Alina V. Niculita, The McGraw-Hill Companies, Inc., 2008, Page 384.

# Adjustments to Value

//// The two most common discounts or adjustments to value are:

- For lack of control (DLOC)
- For lack of marketability (DLOM)

//// These are taken in sequence so if both are relevant, then the effect is multiplicative.

- For example: A DLOC of 10% of value then a DLOM of 25% of value is not 35%, but 32.5%

Equity Value of Ownership Interest	\$ 100,000
Less: DLOC (10%)	(10,000)
	\$ 90,000
Less: DLOM (25%)	(22,500)
	\$ 67,500
<b>Combined Discount</b>	<b>32.5%</b>

# Discount for Lack of Control

- //// Lack control of voting and governance of company.
- //// Lack control and influence of decision making.
- //// Shareholders in public companies lack control too, but some closely-held companies are managed and operated to minimize income and taxes.
- //// A minority shareholder in a closely-held company may have less rights, less transparency.
- //// Shareholder may have no influence on owner and executive compensation, related party expenses, etc.
- //// Shareholder may have no influence on cash distributions, holding period to liquidity/sale, decisions/actions in volatile periods.

# Discount for Lack of Control (cont.)

- //// An appraiser should obtain bylaws and closely-held corporation agreements (or operating agreement).
- //// An appraiser should compare those written agreements to the actual management and operation of the company.
- //// The appraiser's understanding of the above should be part of qualitative analysis in opining on DLOC.

# Discount for Lack of Control (cont.)

## //// What are quantitative factors and analysis on DLOC?

### ■ Control premium data from M&A deals

- Used to impute minority interest discounts (DLOC)
- The data is imperfect because of strategic and synergistic premiums being part of total premium

### ■ Closed-end funds market data

- This pool of funds has market data indicating a discounted price paid relative to total net asset value
- There are fewer closed-end funds because of shifts in investor demand and structural limitations

### ■ Real estate partnership market data

- This pool of partnerships and market data indicate a discounted price paid relative to total net asset value
- There are fewer real estate partnerships because of shifts in investor demand and increasing tax complexities

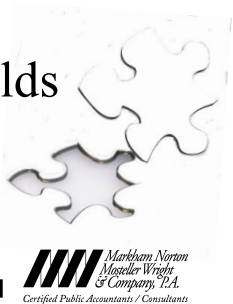


# Discount for Lack of Control (cont.)

- //// Studies show that indicated discounts for lack of control are decreasing.
- //// M&A deals: median of control premiums decreased from 43.0% to 29.8%.
- //// Real estate LP market data: discounts to NAV dropped from 34.0% to 20.0%.
- //// There are more investor rights and more transparency from publicly traded companies.
- //// If the trend has decreased and there is less market data available, how does an appraiser support DLOC?

# Alternative Technique for DLOC

- //// Use more qualitative analysis than in the past.
- //// Use technique of putting multiple on only the annual profits and cash flow that are available to a minority shareholder.
- //// Consider the dividend yield and capacity available to generate a return to the minority owner (beyond tax).
- //// Consider using the actual capital structure rather than a leveraged one that yields a higher multiple.



# DLOC in a Volatile Economy

- //// An appraiser should consider the impact of volatile economic conditions in assessing the DLOC too.
- //// There are then more qualitative and other reasons to support an effective DLOC.
- //// Minority investors in companies with bank and other debt, particularly at higher interest rates, will demand a higher DLOC.

# Discount for Lack of Control (cont.)

- //// On the gift or estate tax return, the preparer will report a 0% discount for lack of control, but the effective discount of using a smaller annual cash flow stream may be significant.
- //// The appraiser can impute the discount effect compared to a larger annual cash flow stream.
  - This technique is used by many appraisers, but not all. Consider this in your review of reports
- //// Some closely-held companies with outside investors and/or management investment may not have a material difference between recasted cash flow to a 100% investor vs. a minority investor.
- //// But in certain engagements, it's a family-owned company with next generation shareholders that will not receive the same economic returns as the founder and will have long holding period.



# Discount for Lack of Marketability

- //// A reduction in value due to the difficulty of selling the share or unit quickly.
- //// Contrast the sale of a share in a closely-held corp. versus a share in a public company.
- //// An appraiser should obtain bylaws and closely-held corp. agreement (or operating agreement).
- //// An appraiser should compare those written agreements to the actual management and operation of the company.
- //// The appraiser's understanding of the above should be part of the qualitative analysis in opining on DLDM.



# Discount for Lack of Marketability (cont.)

- //// First, there may be no market or a limited market for a minority block of shares in a closely-held business.
  
- //// Additionally, many closely-held companies with multiple shareholders want to keep it closely-held and have written agreements restricting the transfer of shares, limiting the ability to sell a share quickly.
  - For example: Why make an offer for a 10% block of shares if the shares would be restricted and often are subject to the current shareholders having a right of first refusal to buy the shares at the same offer price. Then there is no market or a limited market.
  
- //// In some appraisals, the agreements may be undergoing drafting or restating.
  
- //// Appraisers need at least the term sheet or a draft of the restrictions and rights to conduct the qualitative analysis needed to opine on a DLOM.

# Discount for Lack of Marketability (cont.)

- //// Some studies and option models show that indicated discounts for lack of marketability have been decreasing.
- //// Benchmarks of restricted stocks are market data with a 2-year holding period.
- //// Chaffe Options Model: implied discount for 3-year option dropped from 13.5% to 9.0%.
- //// Finnerty Model: implied discount for 3-year option dropped from 9.4% to 7.5%.
- //// The market data and appetite for aggressively discounting has changed as there has been an increase in the availability of secondary markets (e.g. private equity platforms).
- //// There are other alternative liquidity paths too.
- //// Many industries have been consolidating with private equity investments funding growth efforts.



# Discount for Lack of Marketability (cont.)

- //// Indicated DLOM's are higher in industries with longer exit horizons (e.g. early-stage).
- //// The length of the expected holding period of the shares is a key factor in opining on a DLOM.
- //// Another key factor is the expected cash dividend paying capacity of the company.
- //// The written policy of a company should be compared to the actual cash dividend history.

## Discount for Lack of Marketability (cont.)

- //// Appraisers have used restricted stock studies for years and they are still relevant.
- //// Appraisers now place less or no weight on pre-IPO studies due to limited data.
- //// There are now option models to attempt to quantify DLOM more rigorously.
- //// Those models are harder to use and harder to explain to clients and other users.
- //// Option models are based on “put” options (based on price movement) and many closely-held companies do not offer “put” rights to minority shareholders.

# Discount for Lack of Marketability (cont.)

- //// Option models became more prevalent with changes in financial reporting for stock-based compensation. Besides Chaffe and Finnerty models, LEAPS analysis may be used to see a minimum indication of DLOM from puts from “comparable” larger, often diversified companies.
- //// Large auditing firms expect appraisers to consider various option models, which has caused some appraisers to use these options models in all types of assignments.
- //// An assignment for financial reporting is different from an assignment for estate and gift purposes.
- //// Models based on “put” options may be inconsistent with closely-held markets and with restricted stock studies that are still relevant for appraisals of interests for estate and gift purposes.



# Discount for Lack of Marketability (cont.)

//// There are two primary tools to conduct a qualitative analysis in opining on DLOM:

//// One is the List of Factors from Judge Laro in the Mandelbaum Case Decision:

■ Three of the main factors are:

- Expected holding period of the shares or units
- Cash dividend paying history and capacity
- Past and expected volatility of financial performance of the company

//// Second is the IRS Job Aid on DLOM.



## Discount for Lack of Marketability (cont.)

- //// The IRS has a Job Aid on DLOM for their valuation engineers.
- //// This Job Aid was leaked or disclosed and includes the same main factors and many other factors.
- //// The IRS may use option models / other tools to propose adjustments to DLOM.
- //// The IRS may lose sight of the fact that the subject company often offers no “put” option and the subject interest has a longer expected holding period than the investors in the companies in the option models.



## Discount for Lack of Marketability (cont.)

- //// Appraisers are expected to consider all of the Mandelbaum factors and the IRS Job Aid factors on DLOM and address whether the subject interest in the subject company is more or less marketable than those shares in the restricted studies.
- //// When reviewing an appraiser's report, beware of those using court case decisions to support discounts. Case decisions are based on specific facts & circumstances.
- //// DLOM's used to have a baseline of 30-35% of value based on benchmarks.
- //// Appraisers now may start 10% lower than in the past due to consolidating industries, private equity, and other secondary markets.

# Beware of Improper Support for DLOM

- //// If you see an appraisal report that seems to use only restricted stock or pre-IPO studies, beware of the trends, secondary markets, and option models that are prevalent today. There needs to be analysis of the factors for the subject interest.
- //// Also note- the DLOM and above body of knowledge is appropriate when valuing a minority interest, *not* when valuing a 100%/controlling block.
- //// Even a 100% block of stock or the assets of a closely-held company may take longer to sell and lack liquidity, but appraisers should use different resources, e.g. time, costs of sale, to support that discount for lack of liquidity.

# Recap

- Use peak lifetime exemption prior to sunset or changes.
- Use current economic uncertainty and volatility.
- Use levels of value.
- Use amount of cash flow available to minority shareholder.
- Beware of less quantitative data for DLOC.
- Consider option models as floor, but emphasize lack of “put” of subject.
- Use Mandelbaum factors and use IRS Job Aid factors on DLOM.

Any Questions?