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Dealing with a 50% Interest: Should an Adjustment for Control Apply?

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I recently was given an assignment to appraise the fair market value of a 50% interest in a company as one partner wanted to buy the other out. I've appraised a bunch of clear-cut minority interests, but this was my first one where I wasn't sure if the subject was a minority interest or if it had some aspects of control. (Idaho is not a supermajority state.) I read through the typical textbooks, Gary Trugman's book; Understanding Business Valuations, 2nd edition, Shannon Pratt's book; Valuing a Business 4th edition, and Pratt's Business Valuation Discounts and Premiums. I didn't find much information on discounts for lack of control for 50% ownership interests except for a small section on page 28 in Business Valuation Discounts and Premiums quoted below:

> "Interests of 50% are neither control nor minority. A 50% interest usually can prevent corporate actions but cannot cause them to happen. A 50% interest value usually lies about halfway between a controlling interest value and a pure minority value. There is no empirical data for guidance in quantifying 50% interest percentage discounts from control value or premiums over minority value. However, 50% interests sometimes are discounted at about 15% from control value to reflect lack of control. In some circumstances two 50% interests do *not* have equal lack of control. This situation can arise when one of the 50% interests exercises some prerogatives of control under a contractual arrangement. In this case, the discount from control value should be less for the interest with some control prerogatives and a little greater for the interest without the control prerogatives."

In talking with a number of other business appraisers about the discounts that apply to a fifty percent interest, I discovered a few things.

1. It seems that everybody agrees that a discount for lack of marketability applies.
2. Some business appraisers apply a small discount for lack of control and some do not.
3. Those that apply discounts for lack of control don't agree on how to quantify the chosen discount.
4. Some business appraisers state that a discount for lack of control for a fifty percent interest should **NOT** be smaller than those applied to other minority interests.

It seems that the difference between whether or not a business appraiser uses a discount for lack of control depends on how the income stream being used was derived. If controlling adjustments were made, such as adjusting reasonable owner's compensation, or adding back expenses or income pertaining to non-operating assets the business owns, then the value calculated requires some discount in order to apply to a minority interest. This is where a big division occurs. Some business appraisers make the following argument:

Neither a thirty percent interest nor a fifty percent interest has control of the company, so if a control adjusted income stream has been used, then the same size discount for lack of control should apply to a fifty percent interest as to a thirty percent interest.

Appraisers typically start with a baseline discount. Some use Mergerstat data typically in the area of 25%, others use closed end fund discounts with a typical range of 5 to 10% as the baseline discount. The Mergerstat data includes synergies and the thinking of many appraisers today is that it likely overstates the discount for lack of control. Once the baseline discount has been selected and supported, it should be adjusted for the specifics of the company. I use the chart Rand Curtiss developed for the course Developing and Defending Fractional Interest Valuation Premiums and Discounts. This chart is shown below (used by permission):

Discount for Lack of Control Factors

Category	Factor	Rating of (1)	Rating of (0)	Rating of +1
Power	Are voting rights proportionate?	Favor minority	Pro rata to all owners	Favor control
	Is control ownership concentrated?	No	Uncertain	Yes
	Is there minority governance representation?	Yes	For major decisions	No
	Is a change of control likely?	Yes	Uncertain	No
	Does the interest have swing or some control value?	Yes	Uncertain or N/A	No
	Are there undue management restrictions?	Yes	Uncertain or N/A	No
	Can the entity agreement be amended easily?	Yes	Maybe (majority in interest)	No
	Can management be changed easily?	Yes	Maybe (majority)	No
	Is there control over accounting?	Yes	Uncertain or N/A	No
	Are there special protective laws/ provisions?	Yes	Uncertain or N/A	No
	Are there anti-dilutive / pre-emptive rights?	Yes	Uncertain or N/A	No
	Is the period of lack of control limited?	Short term	Medium term	Long-term
Economic	Are distributions proportionate	More to minority	Pro rata to all owners	More to control
	Can management compensation be controlled?	Yes	Uncertain or N/A	No
	Is there a probability of cash calls?	No	Uncertain or N/A	Yes
	Are there discretionary expenses?	No	Uncertain or N/A	Yes
	Are there non-operating assets?	Yes	Uncertain or N/A	No
	Is income growing rapidly?	No	Uncertain or N/A	Yes
	Is the entity stable?	Yes	Uncertain or N/A	No
	Is it in good financial position?	Yes	Uncertain or N/A	No
	Are industry conditions favorable?	Yes	Uncertain or N/A	No

	Are merger/acquisition trends favorable?	Yes	Uncertain or N/A	No
	Is business risk high?	No	Uncertain or N/A	Yes
Category	**Factor**	**Rating of (1)**	**Rating of (0)**	**Rating of +1**
	Is financial risk high?	No	Uncertain or N/A	Yes
	Are government regulations pervasive?	No	Uncertain or N/A	Yes
	Is there extraordinary litigation exposure?	No	Uncertain or N/A	Yes
	Is management of good quality, reputation and integrity?	Yes	Uncertain or N/A	No
	...Is it deep?	Yes	Uncertain or N/A	No
	...Is it dependent on key people?	No	Uncertain or N/A	Yes
	Are owners deeply involved?	Yes	Uncertain or N/A	No
	Are there major uninsured risks?	No	Uncertain or N/A	Yes

Source of Chart: Rand M. Curtiss, Developing and Defending Fractional Interest Valuation Premiums and Discounts. (Plantation, Florida: The Institute of Business Appraisers, Inc., 2003), p. 42.

The following shows the chart being used to modify the baseline discount for lack of control derived from both the Mergerstat data and from closed end fund discounts. A baseline discount of 15% has been used – lower than the Mergerstat data indication of approximately 25% and a little higher than the typical closed end fund discount. It is my belief that the baseline discount for non-controlling interests in closely held businesses is higher than for closed end funds but not as high as the discount derived from the average Mergerstat data.

Analysis of Discount for Lack of Control

Category	Factor	Rating	Reason
Power	Are voting rights proportionate?	0	Pro rata to all owners
	Is control ownership concentrated?	-1	No, equal ownership interests
	Is there minority governance representation?	-1	Both owners have a say
	Is a change of control likely?	-1	Yes, One partner plans to buy out the other
	Does the interest have swing or some control value?	1	No
	Are there undue management restrictions?	1	No
	Can the entity agreement be amended easily?	1	No
	Can management be changed easily?	1	No
	Is there control over accounting?	-1	Yes
	Are there special protective laws/ provisions?	1	No

Category	Factor	Rating	Reason
	Are there anti-dilutive / pre-emptive rights?	1	No
	Is the period of lack of control limited?	1	No, long-term.
Category	**Factor**	**Rating**	**Reason**
Economic	Are distributions proportionate	0	Pro rata to all members
	Can management compensation be controlled?	1	No
	Is there a probability of cash calls?	-1	No
	Are there discretionary expenses?	1	Yes
	Are there non-operating assets?	-1	Yes
	Is income growing rapidly?	1	Yes
	Is the entity stable?	-1	Yes
	Is it in good financial position?	-1	Yes
	Are industry conditions favorable?	-1	Yes
	Are merger/acquisition trends favorable?	0	Uncertain
	Is business risk high?	-1	No
	Is financial risk high?	-1	No
	Are government regulations pervasive?	-1	No
	Is there extraordinary litigation exposure?	-1	No
	Is management of good quality, reputation and integrity?	-1	Yes
	...Is it deep?	1	No
	...Is it dependent on key people?	1	Yes
	Are owners deeply involved?	-1	Yes
	Are there major uninsured risks?	-1	No
Summary	Sum of the Ratings	-4	The sum of the -1 / 0 / +1 ratings above
	Number of Factors Rated	31	The number of factors rated above
	Net Factors	27	The sum of the preceding two numbers
	Net Factors / Factors Rated	87%	The quotient of the preceding two numbers
	Baseline Discount	15%	As described in the report text
Conclusion	Subject Discount	13%	The product of the preceding two numbers

This method of coming up with a discount for lack of control for a non-controlling interest company is still suspect because of the issues with synergies and other factors that influence the data collected by Mergerstat as well as the applicability of data from closed end fund discounts. Many appraisers believe that the control premiums paid for public companies include many different benefits other then just control, and that any discount for lack of control derived from the Mergerstat data is going to be too high. Likewise, the discounts derived from closed end funds may be too low to apply directly to interests in closely held companies.

In valuing a fifty percent interest in a closely held business, some business appraisers argue that a discount for lack of control applies, but it should be smaller then the discount that would apply to any other minority interest because a fifty percent interest owner typically has some control prerogatives that smaller interest holders typically do not. Some calculate the discount the same way they would for any other minority interest, typically using Mergerstat and closed fund discount data, and then arbitrarily cut it in half quoting the comment from Shannon Pratt's book shown above that states that fifty percent interests typically fall halfway between a controlling interest and a true minority interest.

Taking half of a number many agree may be too high is one way of dealing with this issue. However, I don't think that half is necessarily correct either. Who is to say that one third or even less is not the correct number? Obviously each assignment is different and each discount needs to be tailored to fit the requirements of any engagement, but personally I'd like a little more support

Another comment on this issue is that the size of the discount for lack of control depends on the distribution of the remaining fifty percent. It appears that if the remaining fifty percent is split out among many different owners then it would be easier for the fifty percent interest owner to convince one of the others to go his way, thus reducing the size of the discount for lack of control for his interest. However, if the other fifty percent lies in an equal partner, then it would be tougher to make changes, which suggests that the applicable discount for lack of control should be a bit larger. I think that the determination of any discount for lack of control should definitely take this point into consideration.

The business appraisers who do not apply a discount for lack of control when valuing a fifty percent interest seem to prefer to use an income stream that has not been adjusted for control. They leave owner's compensation at it's over market rate, ignore the fees that the company pays to maintain the box seats at Madison Square Gardens, ignore the expense of recreational vehicle purchases and maintenance, and state that since the income stream that is being used is what the owner of the subject interest could take home, then no discount for lack of control applies as it is already factored in with the extra expenses.

This method seemed to me at first, probably the most accurate method for calculating the value of a fifty percent interest, until I started wondering, 'How much control does the subject interest really have over the discretionary expenses?' If the owner of the subject interest didn't benefit from all the extras, or get to have some additional extras of his own, he could block those extras from happening. In some cases where the discretionary expenses are rather blatant, it appears to me that an appraiser should take those into account. For example, what if one owner doesn't like basketball and doesn't want to pay for the box seats? What if a willing, hypothetical seller doesn't want to sell his toys to a hypothetical buyer? Is it correct to assume that ignoring the non-operating expenses, and not applying a discount for lack of control wash each other out in the end?

It was mentioned to me that even though an owner of a fifty percent interest in a company doesn't have absolute control, he does have the ability to prevent any other shareholder from obtaining control, which I believe is a form of control in itself. Actually, a couple of business appraisers who shared their thoughts with me came back with the idea that even if an income stream that is not control adjusted is used, some small discount for lack of control would be appropriate because of some control prerogatives that are generally inherent in a fifty percent interest.

I'm not sure if that is correct either. I was leaning toward that idea until I realized that applying a discount for the **LACK** of control to value an interest that has some aspects of control, and doing so after using an income stream that was not even control adjusted just didn't make much sense. If one were to use a non-controlling income stream to value a fifty percent interest that inherently has some aspects of control, it seems that one would do better by applying some small measure of a control premium instead.

After the above discussion, I think that those business appraisers who use a control adjusted income stream and apply a smaller discount for lack of control than one would normally apply to value any other minority interest using a control adjusted income stream have probably been doing it the best of any other method I've heard talked about.

I'm still not sure how one would go about supporting the size of a smaller discount for lack of control as the data we have available from Mergerstat contains premiums paid for many other benefits besides control and there is no way to separate them out or even know what they all are and the data for closed end fund discounts also has problems. It does appear to me that most business appraisers agree that the discounts imputed from the Mergerstat control premiums illustrate the high end of the scale, and I feel that closed end fund discounts probably represent the lower end of the scale. Just where in between the baseline number should be appears to be up to the appraiser.

Rand Curtiss gave me a purely conceptual insight that I really liked. He gave me the following equations and is quoted below:

Control Premium = Legal Power times Economic Benefit

or

Discount for Lack of Control = Lack of Legal Power times Lack of Economic Benefit

> "In other words, there are two dimensions to control: the authority to do something, and the ability to gain economically. If a company is cash flow negative, the control owner has the right to raise her salary, but there's no money with which to do it. So the Control Premium is 0. (Positive Legal Power times Zero Economic Benefit = Zero Premium). Or if the company's bylaws require all shareholders to approve management pay and the company is gushing cash, Legal Power = Zero and the Economic Benefit is high, and the product is still zero."

Now if there was only some way to translate this concept into actual numbers that we could use, then we could quantify the discount for lack of control without relying on data that doesn't really fit what we're asking of it.

Until that happens, I believe that the best course of action is to continue to use an income stream that has been adjusted for control, and then apply a small discount for lack of control with an explanation of what the small discount is being used to offset, i.e. the enjoyment of some control prerogatives. Even if a fifty percent interest doesn't have absolute control, a fifty percent interest can still make certain that undesired events don't occur. That is definitely a prerogative that I would associate with control.

As for the determination of the small discount for lack of control, I use both the Mergerstat studies and closed end fund discounts to come up with my baseline discount and then run it through the *Analysis of Discount for Lack of Control* chart developed by Rand Curtiss.

Thank you to all the business appraisers who took the time to help me compile this information. I couldn't have come to terms with this issue without your help.

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