

# Editor's Column: Updated Suggestions for the Selection of a Baseline Marketability Discount for Holding Companies

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This is an update to an article published in *Business Appraisal Practice*, Winter 2004-2005 Issue. Since that time, I have read many articles, attended a lot of classes and seminars, and written lots of appraisal reports. I think it is important to realize that discounts exist only because arm's-length sales data for minority interests in privately held companies is extremely limited. Since we don't have good sales data for interests similar to what we often must appraise, we have to use other available data and adjust for the differences.

Clearly the determination of an appropriate Discount for Lack of Marketability (DLOM) for a non-controlling (minority) interest in a holding company such as a family limited partnership is a challenging task. We are all familiar with the various studies and what has been said about them as well as some additional sources of data to assist in determining the discount.

A variety of studies have been made to try to quantify discounts for lack of marketability. According to Gary Trugman in his book, Understanding Business Valuations, the average marketability discount ranges between 25% and 45%.<sup>1</sup>

Chris Mercer in his book, Quantifying Marketability Discounts, states that "marketability discounts can range from very small (in the range of 5% to 10%) to quite large (60% to 80% or more)."<sup>2</sup>

According to Chris Mercer, business appraisers typically site four sources of evidence when they determine the appropriate size of a marketability discount. These sources are:

- Restricted stock studies (measured discounts on sales of restricted shares of publicly traded securities).
- Pre-IPO studies (reviewed discounts on sales of closely held company shares compared to Initial Public Offering prices of the same company shares).
- Cost of flotation studies (the cost to a private company of going public), and
- Tax Court cases.

The first three sources are based on direct market evidence; the last on indirect evidence.<sup>3</sup>

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<sup>1</sup> Gary Trugman, Understanding Business Valuation: A Practical Guide to Valuing Small to Medium-Sized Businesses, Second Edition (New York: American Institute of Certified Public Accountants, Inc., 2002), p. 377.

<sup>2</sup> Z. Christopher Mercer. Quantifying Marketability Discounts: Developing and Supporting Marketability Discounts in the Appraisal of Closely Held Business Interests. (Memphis, Tenn: Peabody Publishing, LP, 1997), p. 29.

<sup>3</sup> Z. Christopher Mercer. Quantifying Marketability Discounts: Developing and Supporting Marketability Discounts in the Appraisal of Closely Held Business Interests. (Memphis, Tenn: Peabody Publishing, LP, 1997), p. 37.

Restricted stock studies are based on studies that measured the discount due to lack of marketability attributed to shares that were unable to be freely traded for a period of time due to some legal or other restriction. Investment companies and later some closed-end mutual funds invested in restricted stocks. The price differentials between the restricted stock and the freely traded stock of a variety of companies formed the basis of these studies.

A number of pre-IPO (Initial Public Offering) studies have also been done to help quantify marketability discounts. These studies compare pre-IPO trades, primarily among insiders, with prices paid later on during Initial Public Offerings.

It is very expensive for a private company to “go public.” During this process, which may or may not be successful, the company must incur substantial costs for accounting (audited statements are required), legal work, and investment bankers. These fees vary dramatically from several percent of the offering for a large company to 25% of the company’s equity value for a small company.<sup>4</sup>

Mercer in a review of Tax Court cases has shown that the circumstances surrounding each case must be considered by the appraiser in selecting the appropriate marketability discount rate. A review of the Tax Court case summary indicates that the court has sustained marketability discounts, where appropriate, ranging between ten and forty percent.<sup>5</sup>

A more recent review of Tax Court cases by Shannon Pratt et al in their book, *Valuing a Business*, indicated that the highest discount for Lack of Marketability recognized to date by the Tax Court was 40%. They also stated, however, that a 50% discount was upheld in an ESOP (Employee Stock Ownership Plan) case.<sup>6</sup>

It should be noted that court decisions should never be used to select a discount rate, however, a review of court cases before selecting a discount rate for an appraisal particularly in the Estate and Gift Tax arena is a prudent thing to do. If the appraiser selects a discount outside of the area normally allowed by the courts, the appraiser had better do a very thorough job supporting the level of discount selected.

There are a number of factors to be reviewed in deciding what level of marketability discount is warranted in appraising an interest in a company. Many business appraisers typically start with the average of a 35% marketability discount as their baseline discount and then adjust the baseline discount up or down based on a review of some factor list such as the following:

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<sup>4</sup> Jay E. Fishman, Shannon P. Pratt, J. Clifford Griffith, and D. Keith Wilson. Guide to Business Valuations. (Fort Worth: Practitioners Publishing Business, 1999) Ninth Edition, Volume 2, p. 8-28, paragraph 803.33.

<sup>5</sup> Z. Christopher Mercer. Quantifying Marketability Discounts: Developing and Supporting Marketability Discounts in the Appraisal of Closely Held Business Interests. (Memphis, Tenn: Peabody Publishing, LP, 1997), p. 465-483.

<sup>6</sup> Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweih. Valuing a Business: The Analysis and Appraisal of Closely Held Companies. Fourth Edition. (New York: McGraw-Hill, 2000), p. 612-613.

### Discount for Lack of Marketability Factors

Category	Factor	Rating of (1)	Rating of (0)	Rating of +1	
<b>Income</b>	Are cash distributions material?	Yes	Income taxes only	Control discretion	
	...Certain?	Yes	Uncertain or N/A	Control discretion	
	...Frequent?	Yes	Uncertain or N/A	Control discretion	
<b>Appreciation</b>	Is the entity diversified?	Yes	Uncertain or N/A	No	
	Is the economic risk high?	No	Uncertain or N/A	Yes	
	...Interest rate risk (considering both assets and liabilities)?	No	Uncertain or N/A	Yes	
	...Stock market/asset price risk?	No	Uncertain or N/A	Yes	
	...Business risk?	No	Uncertain or N/A	Yes	
	...Financial risk?	No	Uncertain or N/A	Yes	
	Are unrealized tax liabilities large?	No	Uncertain or N/A	Yes	
<b>Liquidity</b>	Are growth prospects good?	Yes	Uncertain or N/A	No	
	Are there rights to liquidation?	Yes	Uncertain or N/A	No	
	...Withdrawal/return of capital?	Yes	Uncertain or N/A	No	
	...Assignee admission?	Yes	Uncertain or N/A	No	
	Have there been sales of interests?	Yes	Uncertain or N/A	No	
	Are there transfer restrictions?	No	Uncertain or N/A	Yes	
	Are there insider-trading restrictions?	No	Uncertain or N/A	Yes	
	Is there a right of first refusal?	No	Uncertain or N/A	Yes	
	Is there an active secondary market?	Yes	Uncertain or N/A	No	
	Is the holding period long?	No	Uncertain or N/A	Yes	
	Is there a clear exit strategy?	Yes	Uncertain or N/A	No	
	Are many potential buyers present?	Yes	Uncertain or N/A	No	
	Is there a buy-sell agreement?	Yes	Uncertain or N/A	No	
	Is there put/call protection?	Yes	Uncertain or N/A	No	
	Is there a blockage effect?	No	Uncertain or N/A	Yes	
	<b>Financial</b>	Is there bankruptcy risk?	No	Uncertain or N/A	Yes
		Are current liquid assets material?	Yes	Uncertain or N/A	No
Are capital calls mandatory and probable?		No	Uncertain or N/A	Yes	
Is there unused debt capacity?		Yes	Uncertain or N/A	No	
Are there outside financing sources?		Yes	Uncertain or N/A	No	
Is cash flow strong?		Yes	Uncertain or N/A	No	
...stable?		Yes	Uncertain or N/A	No	
Can the entity change easily?		Yes	Uncertain or N/A	No	
<b>Power</b>	Is information available / reliable?	Yes	Uncertain or N/A	No	
	Are owners harmonious?	Yes	Uncertain or N/A	No	

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. 43.

I propose that business appraisers consider modifying their starting baseline discount instead of simply using the “average of 35%” as a starting point. Based on my personal review of the various studies and my experience in dealing with both business and real estate investors over the last twenty-seven years, I believe that the nature of the underlying asset, the amount of cash

distributions made, and the length of the expected holding period drive the magnitude of the DLOM. I have developed the following chart and suggest it as a guideline for selection of an appropriate baseline DLOM to be modified by factors such as those suggested by Rand Curtiss in his chart shown above:

<b>SELECTION OF A BASELINE DISCOUNT FOR LACK OF MARKETABILITY (DLOM)</b>		
<b>Proposed Baseline Discounts</b>	<b>Investment Characteristics</b>	<b>Expected Holding Period</b>
15%	Cash & Marketable Securities	Likely Short Holding Period
20%	Assets held for sale, including real estate, that are expected to sell in the near future.	Likely Short Holding Period
25%	Publicly traded partnerships, lower quality marketable securities such as infrequently traded public companies.	Likely Short to Medium Holding Period
30%	Income Producing Real Estate with Strong Cash Distributions. Interest(s) in privately held companies with regular, strong cash distributions.	Likely Medium Holding Period
35%	Income Producing Real Estate with Some Cash Distributions and vacant land with current development potential. Also, interests in privately held companies with little or no cash distributions.	Likely Medium Holding Period
40%	Illiquid Assets with Infrequent, Small Cash Distributions such as holdings of vacant land without current development potential. Also interests in higher risk privately held companies with no cash distributions.	Likely Long Holding Period
45%	Illiquid Assets with No Cash Distributions Expected for some time such as holdings of remotely located vacant land. Also interests in privately held companies with no cash distributions and poor future prospects.	Likely Very Long Holding Period

The categories and suggested baseline discounts shown in this table are obviously subjective and are my opinion, however, I believe they provide a more reasonable starting position than simply using the “average of 35%” as a starting point. I suggest that business appraisers consider the type and nature of underlying assets held in the entity being valued specifically considering their cash producing ability and the likely holding period of those assets held in the determination of the baseline DLOM. I believe it is important to not simply select one of the categories. Instead,

after a careful analysis of the underlying assets has been made, perhaps a blend or weighted average of the above categories should be selected as the starting point.

Neither benchmarking nor the QMDM are perfect methodologies. There has been quite a bit written about the weaknesses of each one, and perhaps not enough about their strengths. Benchmarking, properly done, is based on empirical data – actual market observations. The QMDM, properly done, is based on the logical relationship between its component variables. In essence, benchmarking begins with a “typical and appropriate” baseline discount and adds or subtracts to it based on case specific facts. The QMDM begins with a zero discount and builds it up based on rates of return plus the same case specific facts.

A “best practice” is to use both methods with the same case-specific factor ratings to corroborate your discount conclusion. If you arrive at two very different estimates, then something is wrong and you must check your assumptions.

Thanks to Rand Curtiss for his suggestions on this article and for his permission to use the chart from his course.

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