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Editor's Column: Which Discount and/or Premium Applies?

Paul R. Hyde, EA, MCBA, BVAL, ASA, MAI

One of the most challenging areas of the business appraisal field is the applicability and quantification of discounts and premiums (yes, I know that technically they should be called premia, but few people study Latin anymore so I will call them premiums). It should be noted that there are many different of opinions among appraisers regarding discounts and premiums, the appropriate level of value to which they apply, and how they should be quantified. The purpose of this article is to present my view regarding these issues.

First, it should be noted that businesses as well as business interests are not bought and sold with the application of discounts and premiums. Instead, discounts and premiums are the result of utilizing an appraisal method, based on available data, that generates a different level of value conclusion than what is needed to value the subject. It would be ideal if all appraisers agreed on both the concept of Levels of Value and which Level of Value is generated by each appraisal method, however, if this were the case, it would take a lot of fun out of the appraisal field, eliminate many appraisal engagements, and significantly reduce appraisal fees! Seriously, there are many very well thought out points of view that differ from my own – every appraiser should do the necessary reading to develop his or her own opinions, and the ability to support them rationally within their appraisal reports.

The standard of value used in the valuation process has a very large impact on the magnitude of any applicable discounts and premiums -- or on whether or not discounts and premiums should even be applied at all. Using the fair market value standard of value, the specific ownership interest being appraised is being valued "as is," including any control or marketability characteristics of the ownership interest. Because of this, minority interests in closely-held companies are valued to reflect their lack of control and lack of marketability characteristics.[1] In some states, family law courts use the investment value standard of value. In these cases, the appraisal problem is to identify what is called "value to the owner" or the marital community instead of "value in exchange" as is the case in a fair market value standard of value. In cases such as this, when the company is family owned, there may be no minority discount for a minority owner because through family attribution, the owner is assumed to be part of a control group.[2]

Some discounts and premiums apply to an entire entity, others apply only to specific blocks of ownership. These are typically distinguished as entity level discounts and premiums versus "shareholder" level discounts and premiums.[3] "Shareholder" level discounts and premiums often apply to partnerships, limited liability companies, and other entities that do not issue "stock."

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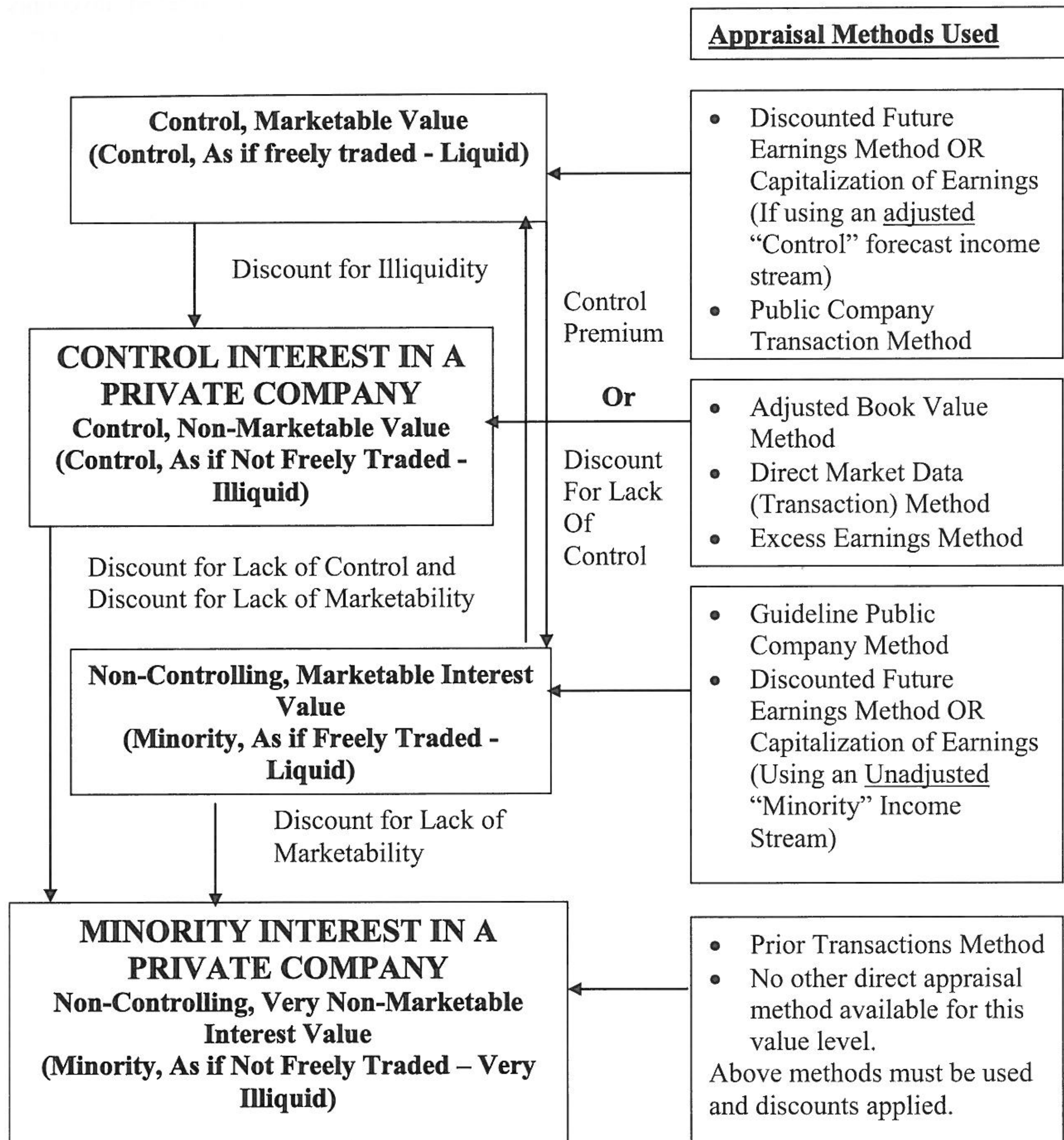
[1] Shannon P. Pratt. Business Valuation Discounts and Premiums. (New York: John Wiley & Sons, Inc., 2001), p. 14.
[2] Shannon P. Pratt. Business Valuation Discounts and Premiums. (New York: John Wiley & Sons, Inc., 2001), p. 14.
[3] Shannon P. Pratt. Business Valuation Discounts and Premiums. (New York: John Wiley & Sons, Inc., 2001), p. 3.

Examples of entity level discounts and premiums are key person and environmental liability discounts. Shareholder level discounts and premiums are most commonly encountered in business appraisals. The most frequent are control premiums, minority interest discounts (perhaps more clearly referred to as discounts for lack of control), and marketability discounts (also known as discounts for lack of marketability).[4] Some marketability discounts are taken from control level values, others from minority ownership levels. Control level discounts are typically smaller. In order to distinguish between the two, I call discounts for lack of marketability from control level values Illiquidity Discounts[5] as controlling interests are less liquid than public companies. Discounts from minority or non-controlling levels of value are called discounts for lack of marketability.[6]

I developed the following chart years ago and have periodically updated it to help me understand and explain which discounts and premiums are needed for each of the common appraisal methods often used in business appraisals:[7]

[4] Jay E. Fishman, Shannon P. Pratt, J. Clifford Griffith, and D. Keith Wilson. Guide to Business Valuations. (Fort Worth: Practitioners Publishing Company, 1999) Ninth Edition, Volume 2, p. 8-14, paragraph 803.3.
[5] Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs. Valuing a Business: The Analysis and Appraisal of Closely Held Companies. Fourth Edition. (New York: McGraw-Hill, 2000), p. 416.
[6] Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs. Valuing a Business: The Analysis and Appraisal of Closely Held Companies. Fourth Edition. (New York: McGraw-Hill, 2000), p. 394.
[7] Hyde, Paul R., "Discounts & Premiums: A Chart to Illustrate Them More Clearly" *Business Appraisal Practice* published by The Institute of Business Appraisers, Inc., Summer 2000, p. 23 and Editor's Column – "Updated Levels of Value Chart" by Paul R. Hyde, EA, MCBA, BVAL, ASA. Published in *Business Appraisal Practice: Journal of The Institute of Business Appraisers, Inc.*, Summer/Fall 2005, p. 2 – 4.



This chart has been included in IBA class materials and has been adopted for use by many appraisers. In the following comments, I present my view as to why each of the appraisal methods listed yields the Level of Value indicated.

Identification of a control interest or a minority (non-controlling) interest in a business is very important. While there may be some technical differences between a minority and a non-controlling interest, for the purpose of this article, I am using them as synonymous terms. A non-controlling or minority interest, by definition, does not have control. Many people believe that a minority interest is worth its proportionate interest in a business—an assumption that is seldom, if ever, correct. For example, a 20% interest in a business valued at $100,000 is not likely to be $20,000—instead, it is likely to be less than $20,000. Minority interests in a business are typically worth less, often a great deal less, than the proportionate share of the business.[8]

According to the above chart there are four different Levels of Value; two of which are controlling and two of which are non-controlling. The main difference between each controlling and non-controlling Level of Value is the applicable liquidity of the interest being valued.

The first level, a Control, Marketable Value is best represented by owning a controlling interest in a public company. A controlling owner can sell shares anytime he or she wants to, subject to SEC rules, and there are literally thousands of buyers all ready to buy that interest.

The second level, a Control, Non-Marketable Value is best represented by owning a controlling interest in a privately held company such as a Mom and Pop corner store. Just because Mom and Pop own a controlling interest in their company, doesn't make it easy to sell, i.e. convert into cash. Mom and Pop can offer their controlling interest for sale, but there is no ready marketplace for their shares. There are not very many buyers around ready to purchase Mom and Pop's controlling interest and there will likely be some cost and time associated with locating them.

The third level is a Non-Controlling, Marketable Value, which is best represented by a public stock portfolio. The general investor in the stock market is buying an interest in a public company at this level. The average investor does not have any control over how the public company is run, but the average investor can also sell his shares at any time and get his cash out within three days or so. This is not possible with the fourth level.

The fourth Level of Value is a Non-Controlling, Very Non-Marketable Value. I call it Very Non-Marketable because this is a non-controlling interest (for example, a ten percent interest) in Mom and Pop's corner store from the above example. Since there are very few buyers ready to buy a controlling interest in Mom and Pop's corner store, how many buyers are ready to buy a non-controlling interest in this same store? The answer is almost always the same -- none.

There are only a relatively few widely recognized business appraisal methods available to business appraisers. The majority of these are included in the chart above. Certain appraisal methods generate an answer to the appraisal problem at a certain Level of Value; however, some methods can be used to determine values at different Levels of Value depending on certain decisions made by the appraiser. As shown above in the chart, the two main Income Approach Methods, the Discounted Future Earnings Method and the Single Period Capitalization Method can generate values on a Control, Marketable Value and a Non-Controlling, Marketable Value.

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[8] 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. 8-15, paragraph 803.4.

The determined value generated by these two methods is either a controlling value or a non-controlling value depending on which income stream the appraiser uses. If the income stream used is what a controlling shareholder could put in his pocket, i.e. adjusted for control issues, then the determined value is at the Control Level of Value. If the income stream is not control adjusted, i.e. that available to a minority shareholder, then the determined value is at the Non-Controlling Level of Value.

Notice that no matter the level determined, the values determined using the Discounted Future Earnings Method or the Single Period Capitalization Method are always considered Marketable. I define Marketable as being able to convert into cash within three days at a known cost. The reason for calling this level Marketable is based on the discount or capitalization rate that is used in the method. Most of the time, these rates are derived largely from data either completely or partially derived from the public markets. Public markets are Marketable – investments can generally be converted into cash within three days. In order to apply a value derived from public market rates to a private non-marketable company, a discount aptly called a Discount for Lack of Marketability is required. As was mentioned previously, I differentiate between Discounts for Lack of Marketability (DLOM) from a Control Level of Value and those DLOMs from a Non-Controlling Level of Value. The reason this is done is that controlling interests are almost always more marketable than non-controlling interests, therefore the size of the DLOM used is generally smaller if it is being applied to a controlling interest, or larger if it is being applied to a non-controlling interest. In an attempt to clarify the issue, I call DLOMs for controlling interests, an Illiquidity Discount.

While the purpose of this article is not "how to quantify discounts", I believe that a few comments regarding Illiquidity Discounts may be necessary for clarification. As has been mentioned, a closely held company cannot be sold by calling a securities broker and receiving cash in three days, which is an advantage for the holders of most publicly traded securities. Instead, a company must typically either be taken public, sold privately to an outside party, or sold to other existing shareholders. Each of these transactions can take a significant amount of time and can be expensive. Further, the owner has a lot of uncertainty as to the amount of time the process will take, the costs, the price that can be realized, the form of payment (some of the proceeds may not be in cash), and the owner typically cannot pledge the stock owned as collateral for a bank loan.[9] As a result, I believe that this discount should approximate the cost of taking the company public, if feasible; if not, the cost involved in selling the company. Depending on the size of the business, the cost of selling it would typically range between eight and twelve percent including brokerage fees, extra accounting fees, and legal fees.

[9] Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs. Valuing a Business: The Analysis and Appraisal of Closely Held Companies. Fourth Edition. (New York: McGraw-Hill, 2000), p. 412-413.

The following are my thoughts regarding each of appraisal methods shown in the Levels of Value chart:

Income Method with a Control Income Stream

Yields a Control, Marketable Value:

- If appraising a Control Interest in a Private Company, an Illiquidity Discount applies.
- If appraising a Minority Interest in a Private Company, it is best to use an Income Method with an Unadjusted Income Stream, i.e. an income stream available to a minority owner – in such cases, only a Discount for Lack of Marketability applies.

Public Company Transaction Method

Yields a Control, Marketable Value:

- If appraising a Control Interest in a Private Company, an Illiquidity Discount applies.
- If appraising a Minority Interest in a Private Company, both a Discount for Lack of Control and a Discount for Lack of Marketability apply. The discounts are multiplicative, not additive meaning apply the DLOC first, then the DLOM to the subtotal.

Adjusted Book Value Method

Yields a Control, Non-Marketable Value – the thought behind this level of value conclusion is that the Adjusted Book Value method requires the ability to access the underlying assets, i.e. requires control.

- If appraising a Control Interest in a Private Company, no discounts or premiums apply. The value is directly applicable to the subject. A caveat is appropriate here – most appraisers consider this method to provide a "floor value" as it typically does not include the value of the intangible assets. A way around this problem is to combine this value conclusion with the value conclusion reached using the Excess Earnings Method which yields the value of the intangible assets only. Some appraisers are horrified with this idea: others, like myself, think it is very helpful and use the combination of the two methods as an indication of value for the company regularly.
- If appraising a Minority Interest in a Private Company, both a Discount for Lack of Control and a Discount for Lack of Marketability apply. Again, it must be noted that this appraisal method does not typically include the value of the intangible assets – be careful! The discounts are multiplicative, not additive, meaning apply the DLOC first, then the DLOM to the subtotal.

Direct Market Data (Transaction) Method

Yields a Control, Non-Marketable Value – the thought behind this level of value conclusion is that the data comes from sales of similar companies, each with similar control and marketability issues.

- If appraising a Control Interest in a Private Company, no discounts or premiums apply. The value is directly applicable to the subject. This is a big benefit to the use of this method if appropriate data is available.
- If appraising a Minority Interest in a Private Company, both a Discount for Lack of Control and a discount for Lack of Marketability apply. The discounts are multiplicative, not additive, meaning apply the DLOC first, then the DLOM to the subtotal.

Excess Earnings Method

Yields a Control, Non-Marketable Value -- the thought behind this level of value conclusion is that the Adjusted Book Value method requires the ability to access the underlying assets, i.e. requires control. A natural question arises when using this method – which income stream should be used? Should a control adjusted income stream be used or, if valuing a minority interest, should a non-adjusted income stream already available to the minority interest be used? I believe that a control adjusted income stream should be used because the method is already considered to be at a control level of value due to the underlying assets.

- If appraising a Control Interest in a Private Company, no discounts or premiums apply. The value is directly applicable to the subject. Remember that this method yields only the value of the intangible assets. If you are trying to value a 100% interest in the company, I believe that it is appropriate to add the value derived from the Excess Earnings method to the value derived by the Adjusted Book Value method to get a value of the enterprise.
- If appraising a Minority Interest in a Private Company, both a Discount for Lack of Control and a discount for Lack of Marketability apply. I combine the Adjusted Book Value method indication with the Excess Earnings method to get a 100% interest indication of value, then apply the discounts. The discounts are multiplicative, not additive, meaning apply the DLOC first, then the DLOM to the subtotal.

Guideline Public Company Method

Yields a Non-Controlling, Marketable Value:

- If appraising a Control Interest in a Private Company, a Control Premium must first be applied, then an Illiquidity Discount. Apply the Control Premium first, then the Illiquidity Discount to the subtotal.
- If appraising a Minority Interest in a Private Company, only a Discount for Lack of Marketability is applicable.

Income Method with a Non-Controlling Income Stream

Yields a Non-Controlling, Marketable Value:

- If appraising a Control Interest in a Private Company, it is best to use an Income Method with a Control Adjusted Income Stream; in such cases, only an Illiquidity Discount applies.
- If appraising a Minority Interest in a Private Company, only a Discount for Lack of Marketability applies.

Prior Transactions (in the stock) Method

Yields a Non-Controlling, Very Non-Marketable Value – the key to the use of this method is establishing that the prior transactions in the minority ownership interests were arm's-length and fairly represent fair market value.

- If appraising a Control Interest in a Private Company, don't use this method!
- If appraising a Minority Interest in a Private Company, no discounts or premiums apply. The value is directly applicable to the subject. This is a big benefit to the use of this method if appropriate data is available.

Summary

Regardless of whether or not you agree with how I approach discounts and premiums, I hope you found this article stimulated your thinking and helped clarify what we, as appraisers, are doing when we apply discounts or premiums in an appraisal. I believe it is important to understand what you are doing and be able to explain it well and thoroughly. I don't mind someone disagreeing with me as long as they understand how I developed my opinion and agree that I explained my position clearly. If this is the case, then I believe I have done my job well.

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