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**RESTRUCTURING THE LEVELS OF VALUE**

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The valuation profession has written volumes about "levels of value" over the years. The thoughts of many business valuation writers have evolved into what can be termed the Traditional View that has driven much of valuation theory and practice as theorists and practitioners alike have tried to find appropriate benchmarks and methodologies for determining the equivalent marketable and non-marketable values of privately-held securities and other assets. The Traditional View is:

**Strategic Value**

Difference reflects synergies

**Control Value**

Difference reflects the value of control

**Publicly Traded Value**

Difference reflects the value of marketability

**Non-Marketable Minority Value**

The essential thoughts behind the Traditional View are that (1) Publicly Traded Value represents a marketable minority value; (2) control is worth more than liquidity; and (3) strategic value is worth more than control. It is my contention, however, the Traditional View inaccurately describes the levels of value, resulting in erroneous interpretations of empirical evidence and erroneous valuation conclusions. For example, the conventional wisdom has been that the "control premium" regularly measured by MergerStat is proof that Control Value represents a higher level of value than Publicly Traded Value, all other things equal. After all, someone paid a premium to take a publicly traded company private. But does the Traditional View hold if the interpretation given to MergerStat's "control premium" is incorrect, and instead MergerStat measures some portion of the discount imposed on poorly run public companies? Another example of potentially faulty Traditional View logic is the notion that Publicly Traded Value exclusively represents the return expectations of minority stakeholders. But does the Traditional View hold if instead the returns realized on publicly-traded securities represent fungible risk-adjusted returns at which, all things considered, the expectations of controlling and minority interests are indifferent?

When comparing the relative values of controlling and minority interests in the same privately-held company, it is easy to intuit that the ability to control the enterprise is worth more than not having that ability. Hence, all other things equal, Control Value is logically worth more than Minority Value. But that logic does not lead to a conclusion that Control Value is worth more than Publicly Traded Value on a per share basis. For example, imagine a controlling interest in a publicly traded company. The controlling investor is exposed to the same price volatility as the minority investors, but is denied the opportunity to quickly dispose of his interest in the company. This realization suggests that liquidity (because it offers the ability to protect the value of one's investment) is worth more than control on a per share basis once the perquisites of control are recognized in earnings and cash flows. An excellent real world example is the U.S. Government's 79.9% interest in American Insurance Group.

Let us explore the factors that result in different levels of value. When comparing the value drivers of well run publicly traded and well run privately controlled businesses, we find that the only real difference is liquidity or its lack:

| **Public Companies** | **Private Companies** |
|---|---|
| Earnings / Cash Flow | Earnings / Cash Flow |
| Growth | Growth |
| Industry Risk | Industry Risk |
| Size Risk | Size Risk |
| Market Fluctuations | Market Fluctuations |
| **Liquidity** | **No Liquidity** |

Liquidity represents the ability to sell an investment quickly when the investor decides to sell in order to realize gains or to avoid losses. Assuming an equivalent interest in net cash flows (i.e. after deduction of control perquisites), the inability to quickly liquidate a controlling interest in a publicly traded company suggests that its interest in net cash flows is worth less per share than that of the liquid minority shares. This aspect of valuation is observable with the discounts imposed on large block holdings in publicly traded companies.

Some authors recently have been suggesting a Modified View wherein control value and publicly traded value may be very close to the same. Nevertheless, it is this author's opinion that the Modified View is also incorrect. Instead, the levels of value should be viewed this way –

**Publicly Traded Value**

Difference reflects the economic risk of lack of liquidity

**Non-Marketable Control Value**

Difference reflects the economic risk of lack of control

**Non-Marketable Minority Value**

The basis of this Restructured View is straightforward. First, the investment returns of publicly traded companies should be viewed as "public company returns" not as "marketable minority returns."[1] For well run companies that are operating optimally for their shareholders, there should be no economic difference between public company operating results and operating results realized (before the expense of control perquisites) by controlling interests of otherwise identical private companies because the material perquisites of control have been squeezed out of the public companies. If this were not essentially true then publicly traded companies would not be able to attract capital in the form of fractional ownership because they would be at a competitive disadvantage vis-à-vis well run private companies. And, in fact, poorly run public companies (i.e. those not operating optimally for their shareholders) have difficulty maintaining shareholder value and raising new capital.

Second, strategic value does not enter into the determination of required rates of return. Strategic events represent anticipated impacts on earnings and cash flow that are appropriately included in the valuation analysis as normalization adjustments. The benefits of strategic acquisitions are shared among all owners of the surviving company as revenues are enhanced and expenses are minimized. It is such benefits that contribute to increased enterprise value.

A closer look at the Restructured View explains that the relationship of levels of value is dependent on combinations of liquidity and management. There are well run publicly traded companies and well run privately held companies. There are also poorly run companies of both types. When a public company is acquired at a premium above its publicly traded value it is a reflection of the perception that the acquired company is not maximizing its economic opportunities and shareholder value. Well-run publicly traded companies (i.e. those that are maximizing their economic opportunities and shareholder value) are not taken private – they are too expensive. Accordingly, the "premium" observed when publicly traded companies are taken private reflects the anticipation that inefficiencies in the acquired company can and will be eliminated. For these reasons, the so-called "control premium studies" are misused when used to suggest that control is worth more than liquidity. Instead, the premium paid represents a sharing of the economic opportunity perceived by the managements of the acquiring and selling companies.

Consider these thoughts: (1) Risk-adjusted rates of return are fungible.[2] (2) Unlike other risk premia, a control premium is not directly measurable.[3] (3) There is a transaction cost to becoming and continuing as a publicly traded company. This creates a disincentive that can only

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2 See Eric W. Nath, ASA, and M. Mark Lee, CFA "Acquisition Premium High Jinks," 2003 International Appraisal Conference, American Society of Appraisers; Eric W. Nath, ASA, "How Public Guideline Companies Represent 'Control' Value for a Private Company," Business Valuation Review, Vol. 16, No. 4, December 1997; and Eric W. Nath, "Control Premiums and Minority Discounts in Private Companies," Business Valuation Review, Vol. 9, No. 2, June 1990.

3 Ibbotson SBBI 2008 Valuation Yearbook, page 42.

be justified by (a) greater access to capital, and (b) the “pop” in value that the pre-IPO owners receive when their business goes public. (4) If control were worth more than liquidity, then the owners of privately held businesses would have a further <u>disincentive</u> to going public. (5) If control were more valuable than liquidity then there would be no public companies as they would all be taken private.[4] (6) If control were worth more than liquidity, then large private equity firms such as Blackstone and KKR would not be converting to publicly traded companies. Thus it seems counter-intuitive that control should be viewed as equal in value to – or even more valuable than – liquidity.

Under otherwise identical circumstances, any given investment should have a greater value if it is immediately marketable than if it is not. This is so because liquidity allows the investor to avoid the economic risks of illiquidity. Moreover, the notion of a control premium vis-à-vis public company values is illogical. Such premiums mathematically equate to lower rates of return. But since it is expected that it would take longer to sell a controlling interest in an optimally run private company than an interest in an otherwise identical public company (a fact that opens the investor up to increased risk), the required rate of return of the private company investor should be greater, not lower, than that of the public company investor. Thus, private company values should reflect a discount, not a premium, relative to comparable public company values.

**Figure 1**

**EXPANDED RESTRUCTURED VIEW OF THE LEVELS OF BUSINESS VALUE**

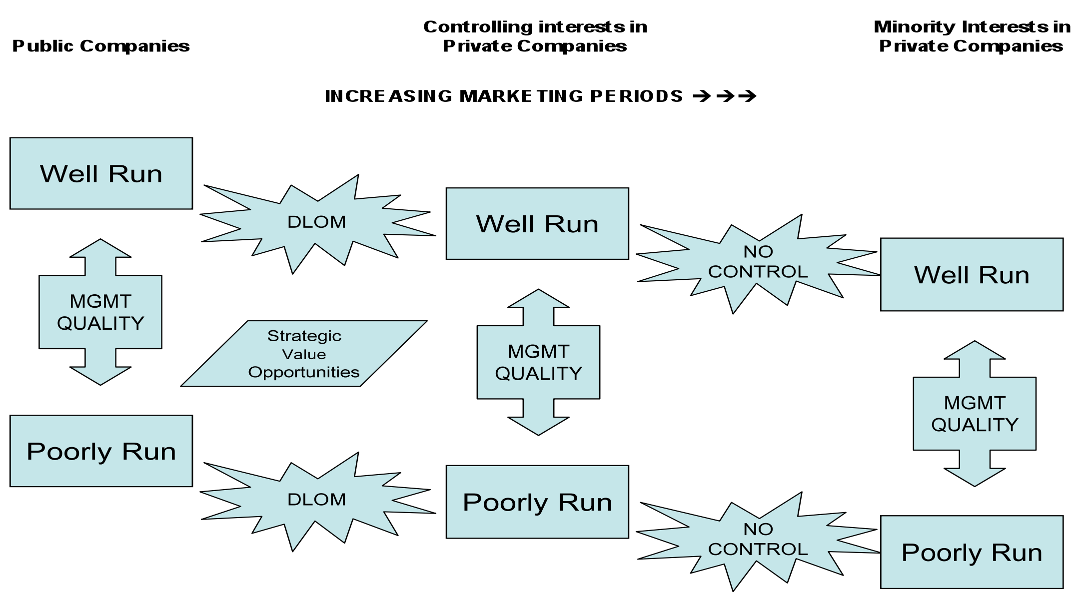


Figure 1 presents my Restructured View of the relative levels of business investment value in greater dimension. The depiction shows how well run and poorly run private companies relate to each other and how the opportunity to realize strategic value (including synergy) arises

[4] <u>Id.</u>

from the conversion of poorly run firms into firms that hopefully will be well run. The depiction also demonstrates that all privately held companies – even controlling interests – are subject to the cost of illiquidity.[5] Even assuming all other things being equal, it simply takes longer to sell a controlling interest in a privately held business than it takes to sell an interest in a publicly traded company. Therefore, relative to an otherwise identical publicly traded company, a privately held company is worth less precisely because its ownership interests are illiquid.

But how does the notion of superior public company value reconcile with those occasions when a privately held company takes a publicly traded company private? The answer lies in the skill with which the respective management exploits economic opportunity, which necessarily is reflected in the companies' respective earnings and cash flows. Strategic opportunity resides in management's ability to optimize value by converting poorly run companies into well run companies. Relative to sales and assets, the well run acquiring company would be expected to create more earnings and net cash flow than the poorly run acquired company. Thus, a well run privately held acquirer may be worth more in absolute terms than an otherwise identical poorly run public company that fails to deliver comparable earnings and cash flows. Nevertheless, a dollar of earnings and cash flows of the publicly traded company will be worth more than a dollar of earnings and cash flows of the privately held company precisely because of the liquidity enjoyed by the public company shareholders.

The illiquidity of controlling interests relative to public company investors represents an inability to realize gains and to avoid losses that has an economic cost that can be estimated using the VFC Longstaff Methodology.[6] This approach requires estimating the period of time it will take to sell the controlling interest and the price volatility to which the interest will be subject during that holding period. These factors will vary with circumstantial changes in the economy and the subject company.

Figure 1 also depicts that minority interests in privately held companies are worth proportionately less than controlling interests in the same company. There are two reasons for this: (1) minorities generally lack the ability of controlling owners to realize the perquisites of ownership, and (2) the economic risks of lack of control result in longer periods of time to sell

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[5] It has been suggested by some practitioners that discounts for lack of liquidity should be applied to minority interests but not to controlling interests. Their logic is that the continuing earnings and cash flows of the company that accrue to controlling interests offset DLOM while the interest is being held for sale. This argument fails because (1) the economic circumstance of holding period earnings and cash flow also exists for minority interests; (2) investment values necessarily already include earnings and cash flows of the holding period because they are capitalized or discounted to arrive at value; and (3) it relies on a flawed view of the levels of value that ignores the facts that (a) rates of return derive from analysis of publicly traded stocks, and (b) liquidity is the only driver of value of publicly traded companies not present in privately held companies.

[6] Francis A. Longstaff, "How Much Can Marketability Affect Security Values?", The Journal of Finance, Volume I, No. 5, December 1995. For an in-depth discussion of the VFC Longstaff Methodology see my article entitled, "Calculating DLOM using the VFC Longstaff Methodology."

minority interests than it takes to sell the controlling interest in the same private company. The first reason is reflected in the earnings and cash flows of the company (representing a direct measurement of minority discount), and does not require a separate valuation adjustment. But the second reason is not reflected in earnings and cash flows, and it is this aspect of valuation that requires that minority interests recognize a greater discount for lack of marketability than controlling interests must realize.

Many practitioners have relied on MergerStat's studies to assume a discount applicable to minority interests in privately held businesses. This approach is defective. The implied MergerStat minority discount is the reciprocal of the implied MergerStat control premium. However, since the premium measures the deficiencies of existing management (or a portion of the value of an opportunity perceived by new management) instead of the value of control, the reciprocal cannot measure minority discount. Let's assume a well run privately held company with absolutely no perquisites accruing to the controlling interest. On a proportionate basis the values of the controlling and minority interests should be the same since each would be receiving an equivalent portion of the earnings and cash flows of the enterprise. Nevertheless, the minority interest is worth less than the proportionate value of the controlling interest because uncertainty that the absence of control perquisites will continue indefinitely (a risk that will be inherited by each subsequent holder of the minority interest) logically results in a longer period of time to sell the minority interest than to sell the controlling interest. During the extended marketing period, the minority is exposed to greater risks of failing to realize gains and failing to avoid losses (including losses resulting from the creation of controlling interest perquisites) than the controlling interest. Therefore, the minority interest is worth less than its proportionate interest in the company.

An appropriate means of determining the lesser value of a minority interest in a privately held company is a four step process: (1) recognition that earnings and cash flows distributable to the minority interest already reflect the existing perquisites accruing to the controlling interest; (2) adjustment of earnings and cash flows for known or reasonably anticipated changes in controlling interest perquisites; (3) estimation of the additional time required to sell the minority interest than the associated controlling interest; and (4) calculation of the additional economic cost of the longer marketing period of the minority interest. Steps one and two are dependent on the facts and circumstances of the subject company. Step three is dependent on both the facts and circumstances of the subject company and prevailing economic circumstances. Step four is dependent on prevailing economic circumstances. Again, the additional cost of illiquidity imposed on minority interests in privately held can be estimated using the VFC Longstaff Methodology.

In conclusion, business values are based on fungible risk-adjusted returns that are ascertainable from analysis of public company stocks. The estimation of discounts for lack of marketability should come from the same source. The difference in value between otherwise identical publicly traded and privately held companies is that the former offer liquidity to their shareholders, while the latter do not. Shareholders in publicly held companies have a greater ability to realize gains and to avoid losses than investors in privately held companies during periods when selling the investment is desired. This results in an ownership interest in a privately held company being worth less per dollar of earnings and cash flows than the equivalent interest in an otherwise identical publicly traded company. Minority interests in privately held companies are worth less per dollar of earnings and cash flows than controlling interests because the uncertainty associated with the creation of controlling interest perquisites is a risk of ownership that increases the period of time necessary to sell the minority interest compared to the time necessary to sell the controlling interest.

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