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NUANCES WITH RESPECT TO VALUING A CONTROLLING OWNERSHIP INTEREST

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Market research and Internal Revenue Service guidance has confirmed that a controlling ownership interest in a business is more valuable than a similar noncontrolling ownership interest. Nevertheless, in particular instances, the governing documents of a business can limit the powers granted to a controlling ownership interest. A valuation analyst must consider such limits when valuing a controlling ownership interest.

Introduction

Empirical market data has shown that a controlling ownership interest is inherently more valuable than an otherwise identical noncontrolling ownership interest. That phenomenon is primarily because a controlling ownership interest typically enjoys the benefits associated with controlling the operational, financial, and investment decision-making of a business.

However, on occasion, the bylaws, articles of incorporation, or other operating agreements of a business may grant that certain decisions require the approval of noncontrolling owner(s) and, therefore, check the powers given to the controlling owner(s).

To accurately capture the economic value associated with controlling a business, it is important that a valuation analyst understands the specific characteristics and rights granted to the controlling ownership interest. Otherwise, a valuation analyst may mistakenly apply a control premium to such an interest when it would be more accurate to instead (1) apply a discount for lack of control ("DLOC") and/or (2) apply a discount for lack of marketability ("DLOM") to the same interest.

The Concept of Ownership Control

A controlling ownership interest, when compared to an otherwise identical noncontrolling interest, often has a higher value, sometimes substantially higher. This difference in value, from the perspective of a noncontrolling ownership interest, is referred to as the DLOC. From the perspective of a controlling ownership interest, the difference in value is referred to as a control premium. This relative difference in value is often thought to exist because the controlling ownership interest can influence and/or fully control the decision-making process of a business.

However, the ability to influence the decision-making of a business does not inherently have economic value. Rather, the higher value associated with a controlling ownership interest is a result of the controlling owner being able to use their decision-making influence to increase the cash flow of a business or lower the required rate of return of a business.[1] An owner of a controlling interest can achieve these two objectives by exercising the so-called prerogatives of control.

Presented below is a non-exhaustive list of some of the more common prerogatives of control:

- Replacing the current management team with more competent individuals
- Setting the compensation levels of employees
- Declaring distributions to shareholders
- Purchasing and/or selling the assets of the business
- Adding debt capital to the business
- Liquidating, selling, or dissolving the business
- Amending the incorporating documents of the business
- Running the day-to-day operations of the business
- Selecting whom the business works with

A valuation analyst also can rely on the guidance provided by Internal Revenue Service Ruling 59-60, which states that control of a corporation, actual or in effect, representing as it does an added element of value, may justify a higher value for a specific block of stock.[2]

Furthermore, a noncontrolling ownership interest is typically viewed by potential buyers as a riskier investment and, therefore, worth less than an otherwise identical controlling ownership interest. The increased risk associated with a noncontrolling ownership interest is because (1) the noncontrolling owner does not have any prerogatives of control and (2) a controlling owner may use their prerogatives of control in a way that negatively affects the noncontrolling ownership interest.

The increased risk associated with lack of control may also subject a noncontrolling ownership interest to a DLOM. This additional risk could be due to the


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Having the prerogatives of control is valuable only if a controlling owner can use those prerogatives to improve the finances of a business.

inability of a noncontrolling owner to exercise the prerogatives of control to achieve some form of liquidity or, alternatively, the risk that a controlling owner could use their prerogatives of control in a way that would negatively affect the marketability of the noncontrolling ownership interest. The amount of risk associated with a noncontrolling ownership interest depends on the specific characteristics of the subject business and the specific powers, if any, that are granted to the subject noncontrolling ownership interest.

To justify applying a control premium in the sale or transfer of a controlling ownership interest, a valuation analyst should first estimate the fair market value of all the business's ownership interests. One common definition of fair market value is the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.[3]

Regarding a controlling ownership interest, a key consideration is that both parties to a transaction have reasonable knowledge of facts about the specific characteristics of the subject ownership interest and the subject business. For example, a rational buyer, with full knowledge that the business they want to acquire a controlling ownership interest in operates efficiently and competently would not likely pay a significant control premium (if any) for that controlling ownership interest. That is because it would be difficult to increase the cash flow of the business (or lower the required rate of return for such a business) when it already operates at peak efficiency.

However, if a rational buyer knew that the current management team ran the same business inefficiently, the buyer likely would be willing to pay some level of control premium because they could use their prerogatives of control to improve the operations and earnings (or reduce the risk) of the business.

However, it may be difficult for a valuation analyst to assign a specific control premium to the inherent influence that comes with owning a controlling ownership interest in a business because every company is unique. A controlling ownership interest in one business may have significantly different circumstances and characteristics—and, thus, abilities to exercise the prerogatives of control—compared to another business.

So, in the context of analyzing whether to apply a control premium to a subject ownership interest (or, inversely, a DLOC), a valuation analyst should review the organizational and governing documents of a business. These documents discuss the powers granted to the different classes of partners, stockholders, or members, depending on the type of business.

By performing such a review, a valuation analyst would follow Internal Revenue Service professional guidance, which states that a sound valuation is based on all relevant facts, but elements of common sense, informed judgment, and reasonableness must enter the process of weighing those facts and determining their total significance.[4] Understanding the full range of powers granted to the subject ownership interest allows the valuation analyst to make an informed decision as to whether they have been tasked with valuing a noncontrolling ownership interest or a controlling ownership interest.

Example: Valuing a Controlling Interest

To accurately capture the economic value associated with owning a controlling ownership interest, it is important that a valuation analyst fully understands the powers granted, not only to the controlling owner but also to the noncontrolling owner or owners. To achieve this, the valuation analyst should review the governing documents of the subject business. This is true regardless of whether the subject business is a partnership, limited liability company, corporation, or any other form of entity. Otherwise, the valuation analyst may misinterpret the true scope of powers awarded to a controlling owner. Additionally, the valuation analyst would not be aware of any scenarios in which the otherwise controlling owner may have their power checked by a noncontrolling owner or owners.

The following example provides an instance where the holder of a majority ownership interest in a hypothetical company is unable to unilaterally control the business. Such an example also illustrates how a valuation analyst would estimate the appropriate size of a valuation discount, if any were warranted, by weighing the advantages of owning a controlling ownership interest.

In this example, let us assume that the valuation analyst has been assigned with valuing a block of voting stock of XYZ, Inc. ("XYZ"). The premise of value is fair market value. The valuation analyst's client, who is the chief executive officer of XYZ, is approaching retirement age and wants to gift their block of voting stock to their children. The client notes that the block of voting stock of XYZ that the valuation analyst is to value represents 100 percent of all voting stock of the company.

A VALUATION ANALYST SHOULD REVIEW THE ORGANIZATIONAL AND GOVERNING DOCUMENTS OF A BUSINESS.

Reviewing the most recent list of XYZ stockholders confirms that the subject block of voting stock indeed represents all outstanding voting stock of XYZ. At face value, the subject XYZ voting stock appears to be a controlling ownership interest in the company because the owner of the subject XYZ voting stock has sole authority on matters that require a vote to decide on a course of action. However, the valuation analyst also notes that the subject block of voting stock represents only 10 percent of all outstanding stock. To confirm that the subject XYZ voting stock is a controlling interest, the valuation analyst should conduct further due diligence into XYZ.

Next, the valuation analyst reviews the most current version of the articles of incorporation of XYZ (the "Articles of Incorporation"), focusing on matters that require voting. The valuation analyst discovers that a shareholder vote is required to take actions related to several common prerogatives of control. For XYZ, a simple majority of 51 percent of the voting stock is required for approval of (1) removing executive-level employees, (2) buying and selling XYZ tangible and intangible assets, (3) financing debt, (4) liquidating XYZ, and (5) running the day-to-day-operations of XYZ.

Given that the subject stock consists of 100 percent of all outstanding voting stock of the company, none of above would suggest to the valuation analyst that they are valuing anything other than a controlling ownership interest. However, during due diligence interviews with XYZ management and after reviewing the company's financial statements, the valuation analyst learns that XYZ has a history of increasing profitability and earnings, but the company has no history of paying any distributions to shareholders.

In reading the Articles of Incorporation, the valuation analyst arrives at a section that states that a 75 percent supermajority of all stockholders is necessary to approve distributions. Reading this, the analyst understands that even a holder of 100 percent of the outstanding voting stock of XYZ is unable to act with respect to distribution payments. It raises the question: If noncontrolling shareholders can influence the payment of distributions, why have they not done so?

Reaching back out to the client with this question, the valuation analyst discovers that a group of stockholders who own approximately 30 percent of the total outstanding stock of XYZ adamantly believe that the long-term growth of XYZ would be better served by reinvesting capital back into the operations of XYZ, rather than paying shareholder distributions. Accordingly, despite not owning any voting stock, this group of stockholders is able to significantly influence the company distribution policy. Further, based on the position of that shareholder group, the subject XYZ voting stock apparently would not be able to obtain any form of liquidity throughout the life of the investment.

To potentially overcome this hurdle to liquidity, the valuation analyst searches the Articles of Incorporation for any mention of setting the compensation levels of employees or amending the Articles of Incorporation. The rationale being that the owner of the subject XYZ voting stock could (1) hire themself as an employee and pay themself a higher salary to compensate for the lack of distribution income or (2) amend the Articles of Incorporation to strip noncontrolling stockholders of having any say in setting distribution policy. However,

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the analyst discovers that setting compensation levels of employees and amending the Articles of Incorporation also require a 75 percent supermajority of all stockholders. Therefore, a holder of the subject XYZ voting stock cannot unilaterally resolve the lack of liquidity challenge that they face.

A valuation analyst assigned to estimate the fair market value of the subject XYZ voting stock might be unsure how to best approach this lack of liquidity challenge during the analysis. On the one hand, the subject XYZ voting stock enjoys many of the common prerogatives of control, so an owner could increase the cash flow of XYZ and/or lower the required rate of return that XYZ faces. On the other hand, an owner of the subject XYZ voting stock faces a high probability of not receiving any current return on investment until the stock is sold to a third party, XYZ undertakes an initial public offering ("IPO"), or XYZ is liquidated. Therefore, the subject XYZ voting stock faces additional risk because the investor may not realize any cash return on investment for years to come, if at all. The additional risk may suggest a hypothetical willing buyer would demand compensation for that increased risk in the form of a discount on the price of an otherwise controlling ownership interest indication of value.

In the above example, the valuation analyst might consider using the valuation discount guidance provided by several "cost to obtain liquidity" studies. Prominent cost to obtain liquidity studies include "The Seven Percent Solution"[5] and "The Cost of Going Public."[6] These studies analyzed the costs incurred to prepare a company for an IPO and to execute the offering successfully. "The Seven Percent Solution" uncovered that underwriter costs alone, on average, are typically 7 percent of the deal size in an IPO.

Underwriter costs are not the only costs that companies pay during the IPO process. A company also will pay auditing and accounting fees and legal fees. "The Cost of Going Public" calculated that accounting fees and legal fees range from 2.1 percent to 9.6 percent of the IPO proceeds. Because XYZ is a privately held company with no immediate path to an IPO, the accounting and legal fees to prepare XYZ for a hypothetical transaction could be in the range of 5 percent to 10 percent of the XYZ equity value.

Considering the discount guidance provided in "The Seven Percent Solution" and "The Cost of Going Public," the valuation analyst selects a valuation discount of 10 percent. The valuation analyst arrived at that valuation discount by weighing (1) the empirical evidence suggested in the cost to obtain liquidity studies, (2) the prerogatives of control that the subject XYZ voting stock can unilaterally implement, (3) the inability to obtain any immediate liquidity, and (4) the potential long-term horizon that a hypothetical buyer would face before receiving any return on their investment. Based on the characteristics of the subject XYZ voting stock, the valuation analyst concludes that a valuation discount is applicable to reflect the inability of the hypothetical owner to exercise all prerogatives of control to achieve immediate, near-term liquidity. In this way, the valuation analyst is effectively considering attributes related to lack of unilateral control and lack of marketability in the application of a valuation discount.

Summary

When comparing a controlling ownership interest in a business to an otherwise identical noncontrolling ownership interest in that same business, the controlling ownership interest is often more valuable to a hypothetical willing buyer. Investors typically assign greater value to a controlling ownership interest because a controlling ownership interest can decide the operational, financial, and investment future of the business. This decision-making ability is only more valuable to investors if they believe that they could wield their influence to increase the cash flow of the business and/or decrease the required rate of return of the business.

However, on occasion, certain businesses include provisions in their incorporating documents that limit the decision-making capabilities of a controlling ownership interest. When faced with such a situation, it is vital that a valuation analyst fully understands the rights and privileges awarded to the controlling and noncontrolling ownership interests. Guidance from the Internal Revenue Service provides further evidence of the importance of valuation analysts reviewing in detail the governing documents of a business. By not doing so, a valuation analyst may mistakenly assume that the subject interest has unilateral control of a business and, accordingly, apply a control premium to the value when it may instead be justified to apply a DLOC or DLOM.

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References:

1 See, for example, guidance provided by The Appraisal Foundation, “The Measurement and Application of Market Participant Acquisition Premiums,” Valuations in Financial Reporting Valuation Advisory, no. 3 (September 6, 2017): 9-18.

2 Rev. Rul. 59-60, 1959-1 C.B. 237, Section 4.02(g).

3 Rev. Rul. 59-60, 1959-1 C.B. 237, Section 2.02; and Treasury Regulation § 25.2512-1.

4 Rev. Rul. 59-60, 1959-1 C.B. 237, Section 3.01.

5 Hsuan-Chi Chen and Jay Ritter, “The Seven Percent Solution,” The Journal of Finance (June 2000): 1129.

6 Jay Ritter, “The Costs of Going Public,” Journal of Financial Economics (January 1987): 269–281.