Unedited transcript of

Valuation Discounts

from **Business Valuation for Attorneys**
Recorded 06/28/2022

Speaker(s)

Jesse J. Gillett, Willamett Management Associates, Boston
Marc D. Bello, CPA/ABV, CVA, MAFF, Willamette Management Associates, Boston

>>: All right. So now we've covered, you know, the foundation, all the approaches to valuation and, you know, like, in theory we really haven't covered yet this idea of discounts and premiums, and what I want to sort of get into here - perfect, let's go to this level of value chart. Here's the concept, and I think I said something like this a little bit earlier. You take financial control value in sort of in the middle of this chart. It's sort of the third rung up from the bottom. If a business is worth $10, the question is whether 10% of that business is worth a dollar or if it's worth something less. Or maybe there could be a situation where it's worth more. But that's the concept of discounts, is are we looking at a proportionate share of something or do we need to modify it further by a discount for various issues? Marketability, you know, minority status - actually, if we do move along to the next slide, Marc, there's probably eventually we get into what the various discounts are. But first, I suppose let's get into, like, the why, the when and the how. So, like, and sometimes why is going to be prompted by the interest that we're looking at itself. So, you know, here in, like, the second - you know, the first sub-bullet on this slide, we have valuation of less than 50%. And that's not necessarily to say that 50% ownership is always the right threshold, but typically, in situations where you're valuing interest that's not in the majority, you know, that's when you really start to creep into the questions of discounts - right? - is well, look, I don't - you potentially not having control over management, control over corporate governance, ability as that investor to actually do what you please with business, you know, this factor of whether discounts may very

well be appropriate depending on the facts and circumstances starts to come into play. Now, that said, when is - when you discount is somewhat situational. Right? So we talked at length about standard of value earlier. Right? Fair market value. In many instances, if your standard is fair market value and you have less than a controlling interest in a business, you know, it's somewhat typical that discounts are now on the table - right? - because we're talking about hypothetical parties, knowing all the facts and circumstances and, you know, if there would be this general perception, for example, in those facts and circumstances that having less than control is harmful, you know, in theory fair market value starts to bring in the aspect of discounts from that sort of perspective. But fair value, on the other hand, typically, and as Marc would say earlier is - this is a perfect slide to get into. While it might be state by state, jurisdiction by jurisdiction, often, fair value says, look, we don't care that it's a 10% interest or a 20% interest. You're not discounting. Right? Like, the sort of the guidelines that we have or the case law that we have or, you know, law that we have doesn't necessarily allow it. And then - so that was fair market value, fair value. But, you know, the fun - some of the fun stuff is when you get into areas where it's completely ambiguous or there's some kind of a modified standard where, you know, as we discussed earlier, sometimes being collaborating with counsel or asking counsel for, like, the definition of standard, like, sometimes the - it kind of gets passed back into our court, you know, and that could be - it could probably be for many reasons, but, like, an easy example to throw out there is, well, what if you're a neutral appraiser, right? And you have two parties who don't agree on how to interpret something, for example, like, you know, something coming out of a shareholder agreement or, you know, things of that nature where it's just - it's not clear in the language, like, how you're supposed to value something. And I guess moving on to the next stage is - I just want to make sure we cover, you know, what is really potentially on the table here? You know, when we look at, say, the level of value chart, you know, some things are not necessarily obvious from that sort of - I don't want to call it a cookie-cutter chart. It's an excellent chart, by the way. But, like, we've already talked in a way about lack of control, right? We've talked about the absence of having a market. Right? So you've got lack of marketability. Those two items are perhaps most frequently seen when you get into valuation of a non-controlling interest in a venue where it is OK to discount.

What sometimes also becomes relevant is whether or not shares have voting status. Right? So in theory, if I get a seat at the table and I get to vote my shares, in theory I might be happier than the alternative where I really get no say, you know, I've just got some tiny share in the business and my opinion doesn't matter. You know, you can get into some small incremental discounting for that particular attribute of the shares as well. You know - and if we can go back one slide, Marc.

>>: Oh, sorry, Jesse.

>>: Yeah, two more points. You know, it's interesting. It's not always about discounts necessarily, so much as discounts or premiums. OK? So a historical issue that the valuation community as well as other stakeholders have had to tackle is how you deal with the status of the entity of the shares that are being valued, OK? So like an S-Corp or some other pass-through type entity like an LLC or an LLP. When you get into non-controlling or, like, a share-level valuation as opposed to valuing the whole, there could also be differences arising sort of as to the tax status of the entity. You know, for - at one time, many folks believed that there was sort of a premium built into having pass-through status, because you'd avoid dividend taxation, so that second layer of taxation, you know, relative to a C-Corp. And now these days, in a recent conference, we're hearing a few people are actually starting to believe that it's actually worse to be a pass-through entity, at least in the current stages of tax law. I think the jury's still out on a lot of this stuff, and there are certainly differing - differences in opinion, and there's been longstanding controversy about this. But - so things like that can come up as well. And then, at least for our practice, something that's been really uncommon, it's like a blockage discount. And so what that could be is if you have a large block of stock going out into the market, like, the market couldn't handle it, and that might also create a discount. I got to say I'm not super well-versed in that, but I just want to give you there's - it's - it can be a heck of a lot more complicated than, you know, lacking control, lacking marketability. There's probably other - some other things we could jump into as well, but we're not going to. So now, going back, you know, the main stage is lack of control and then lack of marketability being the most prominent issues, typically. Lack of control is an interesting thing. How on earth do you come up with lack of control?

You know, on the one hand, there are many evaluators who will actually bake the discount indirectly into the cash flow and the earnings of the business. Right? So when we think about - you know, Marc walked us through, like, income approach, various exhibits earlier. What happens if those income numbers were already sort of burdened by the, you know, perks of a controlling owner, for example? Right? Like, the owner owns a Ferrari and runs it through the business and that's getting paid for, and as the non-controlling owner, you're already suffering because of it. You could have a valuation that's already lacking control, in theory, before you even have to apply some explicit discount of, you know, 5%, 10%, 15%. Alternatively, there are some data sources but - where you might be able to look at this, but it's I guess for lack of time here, I'll just say it's somewhat imperfect, and we don't necessarily need to get into the weeds of that right now. Moving onto marketability - there's a lot going on in marketability. A lot of it's qualitative. Looking at certain factors that we're going to get into in a second, you know, specifically attributed to the company. There's various publications that you can go look up like certain revenue rulings, the ability to go see studies around restricted stocks in pre-IPO situations to impute discounts. Court decisions as well could tell us about this. Interestingly, there are also - and we said earlier, discounts are kind of a murky area. There some - there are quantitative models as well - right? - that you could run specific to the business to sort of back into the right number for discounts. If we move onto the next slide - Marc loves this - there's discount for lack of marketability job aid through the IRS, if anybody's interested in further reading. It's always good to get their perspective on things as we jump into the stuff. You know, we're not going to read this exhaustive list. And actually, I'll just - I'll say this quickly and then move on from it. There are something like nine or 10 Mandelbaum factors that came from case law I'll just say at this point a long time ago - and Marc can probably correct me as to the right year - where you could go through each of these factors, things like divvying the incapacity, you know, ability to redeem the stock, you know, via some kind of agreement. You know, whether the business is a prospect for a public offering might affect marketability. You can kind of go through some of the stuff step by step and make some kind of assessments of, well, is discount going higher, lower, is it kind of neutral depending on the circumstances of the business itself. Now, on the next slide, you know, here's probably something a little bit easier to grasp. Here's a few quick fundamental issues. Would you prefer to own an interest in a company that's growing, you know, 50% next year or 25% the year after that or something that's not really growing at all, right? That might influence your perspective, you know, same with the ability to extract cash flow. You know, even if you're not going to be able to sell your shares necessarily in the short term, perhaps some kind of illiquidity. Then the ability to say, get a dividend, you know, might be a favorable issue from a marketability liquidity perspective and also a holding period. You probably want the ability to sell at some, you know, point in the near term as opposed to, you know, got to hang on for 30 years before you ever get your money back is also potentially that sort of thing that can influence our ability to order a general thought process around discounts here in marketability. Just a quick note on the order of operations in running the math of discounts - if we come up with a 10% lack of control discount and a 20% marketability discount, the temptation of many people is to say the cumulative effect is 30%. That's not actually how the math works. But it's actually, you know, it might not be that far off. First, you apply to one. Then you get to a new number. Then you apply the second layer of discounts and so on and so forth. So here in this example, you know, that 30% is actually really more like 28% when you do that math. Beyond this, I think we want to get into - oh, here's something around ambiguity. So having a case where a judge says to two parties, get out of my courtroom, like, go hire a joint valuation expert and, you know, make a deal off of that where the context is parties had disagreement over whether or not discounts were appropriate - and this went back to - Marc if you click one for one second. You know, well, what does their shareholder agreement say? And so in this case study, we had agreement that said that they needed to transact off of appraisal value. OK. Well, what on earth is appraisal value? And you'd have to kind of look under the hood. And it's situation to situation. And many agreements will be different. You know, OK, well, interestingly, they use the term fair market value. All right. So light bulbs already start to go off when they use fair market value in relation to the definition of appraisal value. You know, another aspect of the agreement said states that the appraiser is valuing specifically, you know, the shares that are going to transact. We're not transacting or appraising the whole company. We're focusing on specific attributes of the shares. Now, one interpretation of this and so the next part box that's about to show up on the page is that this language could point towards I'll just - we'll call this a hypothetical. It could point towards the application of discounts by use of the language in the way that it's laid out. You know, also, as I actually mentioned earlier, what - you know, you shouldn't call this hypo, even though this is based on a true story. With parties, nobody was thinking of was whether this also brought in the issue of like an S corp difference. You know, potentially at the time, you know, was there a premium for having shares in an S corp versus a C corp? You know, and everybody was focused on lack of marketability and lack of control and whether or not that stuff was relevant. So that's a quick and dirty case study in a nutshell. You know, there are other things that - we don't necessarily need to get into everything. But I guess the general point is every agreement is different. Sometimes, it is unclear between two parties, you know, what these shareholders' agreements mean and how you interpret them. And sometimes, they will defer to us as appraisers. You know, look, sometimes it's somewhat easy on our end. Sometimes it's hard, right? I think of the example - as the second bullet point here - an agreement says, you need to appraise the fair market value of the entire corporation - the entire corporation. So we're now talking about cutting up, and, you know, something that - you can put an entire corporation on the market and try to sell it, right? We could debate this a little bit, but, you know, there's generally not really discounts applied to that. And then the agreement goes on to say - and then you multiply by 33%, and then you're done. Well, OK, if that 33% is, say, one of three owners getting bought out, you don't have discounts, right? So sometimes it's really easy. Sometimes it's really hard. And sometimes there are just other considerations around, you know, liquidity baked in as well, where we can sort of dig up, you know, what is the implications to this as to what it means for discounting versus not discounting? Beyond this - last point, I just want to touch upon in the idea of discounting or not discounting is I want people to be aware that there are hidden discounts that can be baked into the valuation before you even see an appraiser lopping off, you know, 10 - 20% at a time for specific attributes of the shares. So you really need to question what the valuation means before you're even discounting it. You know, and I think classic examples could be, you know, the controlling valuation of the corporation, you know, comes up less than, you know, the book value that's sitting on the balance sheet or less than the cash in the bank or the working capital balance. Then you start to wonder, was this really a sort of, I'd say, thinking outside the box, but, like, thinking clearly and logically - was this really a controlling valuation to begin with, you know, before they then went on to chop the next 20% off for an explicit discount. You know, sometimes cost of capital could happen from implications around this as well. So, like, when Marc was describing the discount rate in an income approach - well, you know, sometimes that cost of capital has, you know, the preferential choices of its current ownership baked in that could differ from a reasonable controlling owner. So you could get some hidden discounts there as well. The other thing is, as Marc talked about, specific - company specific risk earlier, that sort of subjective area of the discount rate. You know, is it possible that factors in that are also sort of crossing over, you know, with what's getting thought about, you know, specific to, you know, the market ability discount as well or the minority discount - just to be on the lookout for sometimes - sometimes things get double counted conceptually, like you can't necessarily see this specific attribution of the double counting, but at least, you know, in theory you can see some double counting sometimes. And that's it for discounts.

>>: And believe it or not, we've worked our way up to the last section of - it's now, you know, completing the task. And, you know, what can you expect at the end of the day as a final work product? And, you know, depending again, on purpose setting matter, you know, if you're talking a gift in a state report, well, there's requirements that you need a qualified appraiser - appraisal, and you're going to get a detailed report that basically walks through the steps that went in and how an appraiser arrived at their value. If you're in a litigation matter and you have where if you're in federal court and an expert's report is their direct testimony, you're going to get a detailed report. Are you in alternative dispute resolution where you're just going to have charts - you want some oral reporting and, you're going to have a discussion with your expert. In lieu of a report, are you just going to answer interrogatories that are going to show the substance grounds and findings of your expert, or are there going to be detailed reports? And, you know, reading the reports - making sure that it defends and summarizes all of the steps taken by the appraiser. And kind of know where the venue of the report is going to end up. You know, it's interesting, even on the gift and estate side or even on

some transactional side, you just never know when an appraisal is going to be called into as evidence or someone is going to need to testify to it.