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How control and marketability affect the value of minority interests

Discounts for lack of control and lack of marketability rank among the most contentious issues when valuing a minority interest in a privately held company. To successfully defend or attack these discounts, it's important to understand the evidence that's used to quantify them.

Degree of control

Minority shareholders lack the power to direct the management and policies of a business enterprise. This can be especially problematic when owning a *private* business interest that isn't subject to the scrutiny of the Securities and Exchange Commission (SEC).

First and foremost, experts must establish whether their preliminary methodology generates a controlling or minority basis of value. For example, the value derived using the cost approach that's based on the combined fair market value of the company's assets and liabilities is likely a *controlling* basis value. Why? Because minority shareholders lack the control needed to sell the company's assets or pay off debts.

Conversely, the value derived using the discounted cash flow method is likely a *minority* basis value if the expert didn't adjust the company's income stream to reflect discretionary items, such as related-party transactions and above-market owners' compensation. If the subject company is professionally managed, a minority interest would still enjoy substantial economic benefits, regardless of whether the owner has a voice in important decisions.

A minority interest in a privately held business is a relatively illiquid asset that generally has no ready market.

Applying DLOCs

Whenever possible, experts address an interest's degree of control by adjusting the projected income stream or returns. But, in some cases, an expert may need to apply a discrete discount for lack of control (DLOC) to arrive at the appropriate basis of value.

There are no empirical studies that directly measure DLOCs. Instead, experts use the mathematical inverse of control premiums observed from public stock transactions. Control premium studies measure the premiums buyers have paid for controlling interests in public companies (on a pro rata basis) over the stock's price per share on the public markets.

Marketability

Marketability refers to the ability to quickly convert property to cash at minimal cost. A minority interest in a privately held business is a relatively illiquid asset that generally has no ready market.

Built-in capital gains: A BIG deal in business valuation

Business valuation experts may need to apply a discount for the tax liability related to built-in gains (BIGs). The discount rests on the notion that a hypothetical buyer would factor into his or her offer price the tax liability for capital gains on appreciated assets. Although many courts now accept BIG discounts, debate continues over how the discount should be calculated.

Some federal courts and the U.S. Tax Court have adopted dollar-for-dollar offsets for the capital gains tax that would be realized upon the immediate sale of real estate or another appreciated asset. For example, in the *Estate of Jensen*, the Tax Court considered the value of an interest in a C corporation that held appreciated assets. It ultimately accepted the estate's dollar-for-dollar approach, noting that the resulting discount fell in the same range as its own present value calculations.

However, the U.S. Tax Court also has rejected this approach on several occasions, depending on the taxpayer's situation and whether a sale appears imminent. Contact a business valuation professional to determine what's right for your situation.

Stock transfers may be restricted by a company's articles of incorporation, bylaws or similar governing documents. These documents may contain provisions calling for waiting periods and rights of first refusal by other shareholders. In many cases, the only "market" that exists is the company's other shareholders — who may have little incentive to buy another shareholder's interest, unless they want to gain control of the business.

Two main sources

When valuing minority interests, experts have historically based discounts for lack of marketability (DLOMs) on two main sources:

1. Restricted stock studies. Public companies may issue restricted stock that's subject to a one-year minimum holding period that limits the pool of eligible buyers. Restricted stock generally sells in private trades at a discount from the price of the company's otherwise identical unrestricted stock.

2. Pre-IPO studies. These studies compare the initial public offering (IPO) price of a company's stock to prices of shares paid before the company went public. Unlike restricted stock studies, pre-IPO studies consider transactions in *private* companies that later went public.

The average and median discounts observed from restricted stock and pre-IPO studies may serve as useful starting points when quantifying DLOMs. The valuation expert also considers company-specific facts and circumstances, such as:

- The company's dividend-paying history,
- The size of distributions,
- The expected holding period,
- The likelihood of a sale,
- Financial performance, and
- Management quality.

The expert must compare the subject company to those in the empirical studies. Factors that make the subject company less marketable than the companies in an empirical study (such as a longer expected holding period, subpar performance and an inexperienced management team) may warrant an above-average DLOM.

Important caveat

Many of the factors used to determine DLOCs and DLOMs overlap. So, experts must make adjustments to avoid double-counting factors when quantifying these discounts. ■

Risky business

FAQs about the cost of capital

Value is a function of economic returns, growth and risk. Under the income approach to valuing a private business interest, an expert discounts the subject company's future earnings using a rate of return based on the risk of the investment.

That discount rate — also known as the "cost of capital" — is often the source of confusion to readers of business valuation reports. Here are answers to common questions that arise when interpreting this part of an expert's analysis.

What is the cost of capital?

The term "cost of capital" refers to the expected rate of return that the market requires to attract funds to a particular investment. The rate of return depends on the perceived risk of the investment. Riskier ones require a higher return, which equates to a lower value.

There are two types of capital: equity and debt. The cost of equity is generally higher than the cost of debt, because debt holders receive regular economic benefits (interest and principal payments). Equity investors receive dividends only at the discretion of management, and they must wait until a sale to receive any appreciation in the value of their investment.

In the past, valuation experts recognized that, because interest expense is tax deductible, the cost of debt should be adjusted to reflect its tax benefits. However, as of 2018, the Tax Cuts and Jobs Act limits the amount of interest expense that's tax deductible for many businesses.

There are exceptions to this limitation for small businesses — generally, those with average annual gross receipts of $25 million or less. And the rules allow certain real estate and farming entities to elect out of the limitation rules. So, the adjustment for taxes to the cost of debt may not be as straightforward as it was under prior law.

How do experts measure risk?

Business valuation professionals use a variety of techniques to estimate the discount rate. When discounting the earnings available to *equity* investors, experts must estimate the cost of equity. There are several market-based rates that can be used to build a meaningful estimate.

The cost of equity typically includes the following components:

- A risk-free rate, based on a long-term government bond,
- A market risk premium, based on historical returns for a stock index over the risk-free rate, and
- A company-specific risk premium, based on the subject company's unique attributes, such as its size, financial performance and industry.

When discounting the earnings available to *both* equity investors and creditors, experts estimate the weighted average cost of capital. This is a blended rate that incorporates the cost of equity and the cost of debt, based on specific percentages of each.

What's the appropriate blend?

When using a weighted average discount rate, there are several choices. An expert can apply the subject company's historical or expected percentages of debt and equity capital. This tends to be appropriate when valuing a minority interest that lacks the control needed to alter the company's capital structure.

Or an expert may choose an industry average capital structure that attempts to capture the company's optimal capital structure. This may be more appropriate when estimating the value of a controlling interest in the business.

Alternatively, an expert may choose a capital structure that's based on a particular buyer's preferences. This may be appropriate, for example, when valuing a business for a potential sale.

Major effect on value

Estimating the discount rate requires many inputs, including the cost of debt and equity and the appropriate blend of each type of financing. Although most variables can be supported by market data, there's an inevitable amount of professional judgment that factors into this decision.

Minor changes in the discount rate can have a major impact on value, so it's important to get it right. Discuss this issue with your business valuation expert and make sure he or she answers all your questions before relying on a value conclusion or using it in a legal proceeding. ■

When good employees go bad

Preventing and detecting employee cyberattacks

Employees are generally a business's first line of defense against cyberattacks. But dishonest workers also can initiate a cyberattack by stealing valuable information from a company's computer network and using it for personal gain.

Theft from the inside

Employees can use personal information from their employer's personnel or customer records to file fictitious tax returns or apply for credit. Or they may steal a secret recipe or R&D specs and then sell them to a competitor.

In another scheme, thieving employees use the information to start up their own business. For example, according to FBI records, an employee of a mortgage company in Ohio recently pleaded guilty to intentionally accessing a protected computer without authorization. Then he used stolen customer lists to start a mortgage business. The perpetrator accessed the records by sending an email containing malware to a co-worker. As a backup plan, the employee also gave a thumb drive to a different co-worker and instructed him to download the company's customer lists onto it.

To catch a thief

Why would trusted employees steal from the hand that feeds them? There are several possible motives. They could be "working" for a competitor or seeking revenge on their employer for perceived wrongs. Sometimes coercion by a third party or the need to pay gambling or addiction-related debts comes into play.

While there are no guarantees against hacking, employers can minimize the risk of insider theft by implementing these best practices:

Monitor applications. The Internet is often the gateway to data theft, so IT personnel should take proactive measures to restrict or monitor employee

use of email accounts, websites, peer-to-peer (P2P) networking, Instant Messaging (IM) protocols and File Transfer Protocol (FTP).

Get physical. Some computer thefts occur the old-fashioned way — with employees absconding with materials after hours or while no one is looking. Typically, an employee will print or photocopy documents and remove them from the workplace hidden in a briefcase or bag. Or employees may copy data to a flash drive.

> The proliferation of wireless communication within the office — including Wi-Fi, Bluetooth and cellular networks — increases a company's risk.

Some dishonest employees simply remove files from cabinets, desks or other storage locations. A tech-savvy employee might remove hard disks from computers, while others could walk out with entire computers. Physical controls — such as locks, surveillance cameras and restrictions to access — can help prevent and deter these schemes. Also, an audit trail of computer use may help locate an employee's access to sensitive data files.

Terminate accounts. When employees leave the company, immediately remove them from all access lists and ask them to return all their means of access to secure accounts, such as laptops and mobile devices. Provide them with copies of any signed confidentiality agreements as a reminder of their legal responsibilities for maintaining data confidentiality.

Respect employees. Create a positive work environment. Treat employees fairly and with respect. This can encourage loyalty and trust, thereby minimizing potential motives for employee theft.

In addition to these threats, wireless communication within the office — including Wi-Fi, Bluetooth and cellular networks — increases a company's risk. Dishonest employees can use phones and tablets to gain access to sensitive information. Deterring this threat can be difficult, but one way is to restrict Wi-Fi only to employees with special passwords or biometric access.

Seek outside help

No company is immune from the inside threat of digital theft by employees. Cases abound of employees who steal data from their companies, using either electronic or physical means. For more information or for help investigating suspicious behavior, contact a forensic accounting professional. ■

Calculating damages for intangibles

Financial experts need some predictable building blocks to construct a reliable estimate of lost profits or reasonable royalties in cases involving intangible assets. Solid supporting evidence is key.

Consistency

Before the expert digs into the data, he or she reviews the plaintiff's complaint, the defendant's answer, and any additional or amended filings related to the case. This level of due diligence applies whether the plaintiff is seeking lost profits or reasonable royalties.

Providing your expert with these documents helps ensure the damages analysis and testimony align with your legal arguments. Specifically, you want the expert's testimony to be consistent with your descriptions of the intangible asset, the damage-triggering event, the injury and the damages period.

Projected vs. actual results

Lost profits are typically the remedy for breach of contract claims involving intangible assets, such as licenses or franchise agreements. Regardless of the method the expert uses to estimate lost profits, he or she will require historical, current and prospective financial and operational data related to the intangibles.

Experts must compare historical financial projections with actual operational results to get a sense of how reliable the owner's projections are. The damages estimate must be reasonable in light of historical results, production or other constraints that might limit damages, and the historical trends and outlook for the particular industry.

A qualified damages expert also will seek evidence of the plaintiff's efforts to mitigate the damages. That includes documentation of the timing, cost, date and effect of any mitigating measures.

Resources for royalties

In intangible asset infringement cases, the most common remedy is reasonable royalties. But this form of economic damages also could apply in breach of contract and other tort claims. Reasonable royalty calculations require a wider scope of evidence than lost profits estimates.

All cases require the expert to consider historical, current and projected financial and operational data, as well as the plaintiff's mitigation efforts. But reasonable royalty estimates also must incorporate comparable asset licensing agreements, as well as factoring in the asset's development costs and current market value.

Help them help you

The earlier you can supply your financial expert with the relevant information to perform his or her analysis, the better. It's important to anticipate the types of data needed to support a lost profits or reasonable royalties estimate. That way, you can start gathering the information before you meet with your expert — and avoid the added cost and frustration that comes with waiting for missing documentation. ■

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