VIEWPOINT ON VALUE

JULY/AUGUST 2016

Spotlight on marketability

How hard is it to sell a business interest? Public stocks can be converted to cash in three days. But it often takes a year or longer to sell a private business. Minority interests in private companies can be even harder to liquidate, because they may be subject to transfer restrictions and lack control over decision-making.

Valuators attempt to quantify the time, costs and uncertainty of selling a business interest through the discount for lack of marketability (DLOM). Here are some frequently asked questions about one of the most debated parts of a valuator's opinion.

When are these discounts appropriate?

The term "marketability" refers to how quickly an investor can convert property to cash at minimal cost and for a relatively certain price. When experts use the market or income approach to value a business, they typically arrive at a fully marketable, cash-equivalent value. The DLOM is an adjustment to the preliminary value estimate that's typically expressed as a percentage discount.

Customarily, the DLOM is taken when valuing *minority* (noncontrolling) interests. A discount also may apply when valuing controlling interests, but such interests can't be sold and liquidated immediately. This is usually referred to as an "illiquidity" discount. It's generally much less than the DLOM on noncontrolling interests for the same company.

What factors affect marketability?

For minority interests, the DLOM typically ranges from 25% to 50%. But it may be higher or lower than this range, depending on the specific characteristics of the interest being valued. Each business interest is unique. The appropriate DLOM depends on a variety of factors.

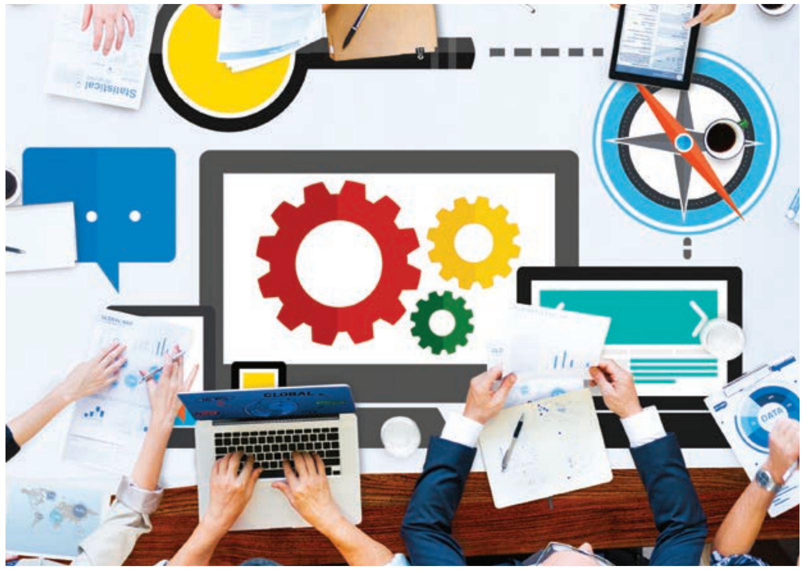
How holding period affects the median DLOM

Holding period	Median discount
0-3 months	21.5%
4-6 months	26.4%
7-9 months	38.9%
10-12 months	46.6%
1-2 years	51.8%
> 2 years	69.4%

In the landmark *Mandelbaum* case, Judge Laro of the U.S. Tax Court enumerated several company characteristics to consider when deciding the appropriate discount:

- Whether the stock is private or public,
- The financial condition according to financial statements,
- The dividend policy,
- The nature of the company and its history, position in the industry, and economic outlook,
- The amount of control in transferred shares,
- Management quality,
- Restrictions on transferability of stock,
- The stock holding period,
- The stock redemption policy, and
- Costs associated with making an initial public offering (IPO).

Other courts and authorities cite additional relevant factors, including the size of revenues and earnings, market volatility, and product and industry risk.



What external data is used to support the DLOM?

Valuators rely on various empirical studies to help support DLOMs. These studies analyze real-world transaction data and try to find relationships between prices paid for stocks on and off the public markets.

The earliest empirical studies — referenced in IRS Revenue Ruling 77-287 — focused on restricted stock. They compared the prices paid for registered shares of publicly traded companies to unregistered (restricted) shares of publicly traded companies. The theory is that investors discount unregistered shares that they can't trade on the public markets for a prescribed time period.

Restricted stock studies became less relevant, however, when the Securities and Exchange Commission (SEC) relaxed its holding-period requirements on restricted stock in 1997. Under previous SEC rules, the holding period was generally two years. The current holding period, effective in February 2008, is only six months.

Another popular source of empirical data for the DLOM is pre-IPO studies. These track transactions in stocks prior to going public and compare them to the stock's IPO price to determine an implied DLOM. Pre-IPO studies have been widely accepted by courts in many jurisdictions, including the U.S. Tax Court.

The largest pre-IPO study is published annually by Valuation Advisors, LLC. The table "How holding period affects the median DLOM" on page 2 summarizes the results from 2015.

The table shows that the size of the discount increases as the timeframe from the date of the IPO increases. This is expected, because the longer it takes to sell an asset, the higher the presumed risk due to the illiquidity of the asset. As the level of illiquidity rises, so does the asset's DLOM. When valuing shares of a privately held company, determining the likely holding period for such shares clearly impacts the value of those shares to a hypothetical investor.

Aside from empirical studies, the DLOM may be quantified using call- and put-option modeling. Options essentially provide investors with the right, but not the obligation, to buy or sell shares at a set price for a specific period of time. Here, the value of the option is calculated to estimate the risk an investor takes that an investment's value could deteriorate over time. In theory, the cost of the option, factoring in the time element, is the implied DLOM.

Why are valuation experts needed?

Some business owners mistakenly believe that they can estimate a holding period for their investment and apply the corresponding discount from a pre-IPO study to their business interest. But these studies are just a starting point.

In fact, if you're estimating a DLOM for federal tax purposes, the IRS specifically criticizes the blind use of averages and medians from empirical studies in *The DLOM Job Aid for IRS Valuation Professionals*. Luckily, a valuator knows how to fine-tune real-world data to match the characteristics of the interest being valued. ■

Focus on fairness

Discounts may apply when valuing shares in oppression cases

The appropriate standard of value when buying out shares in most oppressed shareholder cases is fair value. This standard is defined by state law and typically involves an element of fairness. In other words, a statutory buyout generally can't create a financial incentive for an oppressor to mistreat the company's other owners.

The application of valuation discounts varies from state to state, but it often depends on the facts and circumstances of the case. In *Wisniewski v. Walsh*, the Superior Court of New Jersey granted a sizable discount for lack of marketability (DLOM) to provide equity to the disputing shareholders.

Valuation roadblocks

Three siblings were equal owners in a successful family-owned trucking company. But the shareholders had been arguing in court for over 20 years. Eventually, a trial court determined that the younger brother had oppressed his older brother and sister, and it ordered him to sell his one-third interest back to the company or his siblings "at fair value" as of January 31, 1996.

The oppressor had taken over management of the company when his older brother had gone to prison for fraud. During that time, the younger brother was accused of stopping payment of various bills for his sister that had previously been paid for by the company, switching all line-haul billings and receipts to a related party that wasn't owned by his sister, and excluding both of his siblings from a real estate deal.

The trial court originally valued the oppressor's interest at approximately $12.4 million. But that valuation was reversed on appeal, and the case was remanded for a valuation trial.

Value drivers

Both sides hired appraisal experts for the valuation trial. The oppressor's expert used the discounted cash flow method, which is based on the present value of the income stream the company would be expected to generate for the owner of the interest. The other shareholders' expert used the market approach, deriving the interest's value from the sales of comparable entities. The court set the value of the interest at approximately $32.2 million, based primarily on the discounted cash flow method.

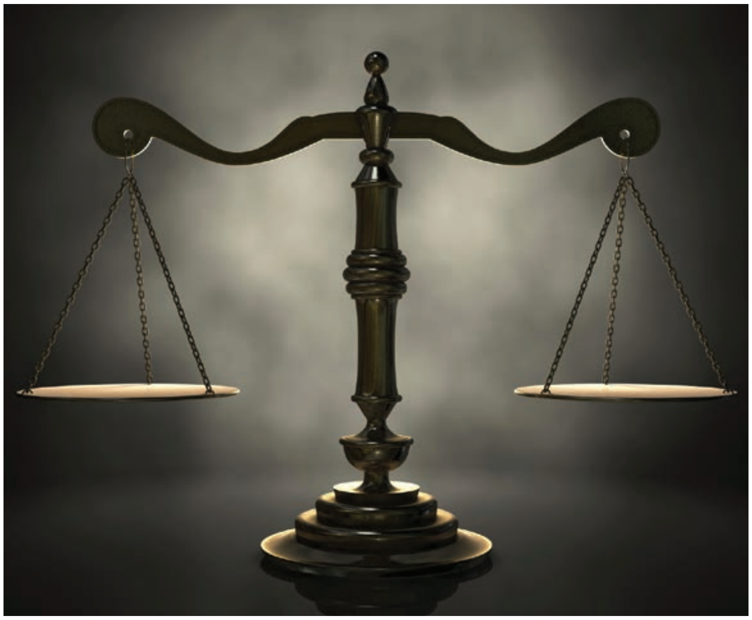
Again, the parties appealed. The appellate court concluded that a DLOM was warranted. But it applied only to the extent that no such discount was already embedded in the valuation method.

> *The reason that the appellate court allowed the DLOM essentially boils down to fairness, but it refrained from establishing any bright-line rules on the applicability of valuation discounts.*

The discounted cash flow methodology didn't include an explicit DLOM, because the valuator didn't believe it was warranted. But the expert did consider some of the same factors that would be used to quantify a DLOM when he built up the 12% discount rate to use in his DCF analysis. Those factors include the company's size, dependence on a key manager, high debt and concentration of its customer base in the retail industry.

The oppressed shareholders' expert, who used the market approach, argued that a 35% DLOM was appropriate based on "applicable studies and legal precedent," including *Mandelbaum*. (See "Spotlight on marketability" on page 2.)

On remand, the trial court determined that a DLOM wasn't embedded in the prior valuation and that a 25% discount — a compromise between the two experts' discounts in order to be fair to both sides — applied. This decision was upheld by the Superior Court of New Jersey.



Paving the way for discounts

The reason that the appellate court allowed the DLOM essentially boils down to fairness, but it refrained from establishing any bright-line rules on the applicability of valuation discounts. The court opinion states, "Absent application of a discount, the oppressing shareholder would receive a windfall, leaving the innocent party to shoulder the entire burden of the asset's illiquidity in any future sale. Equity demanded application of the discount, or else the statute would create an incentive for oppressive behavior."

When valuing minority interests in oppressed shareholder appraisal actions, it's important for valuators to address whether discounts for lack of marketability and control are warranted given the nature of the business and state law. It's also helpful to clarify whether such discounts are otherwise embedded in the valuation analysis. ■

Valuators can take the "stress" out of financial distress

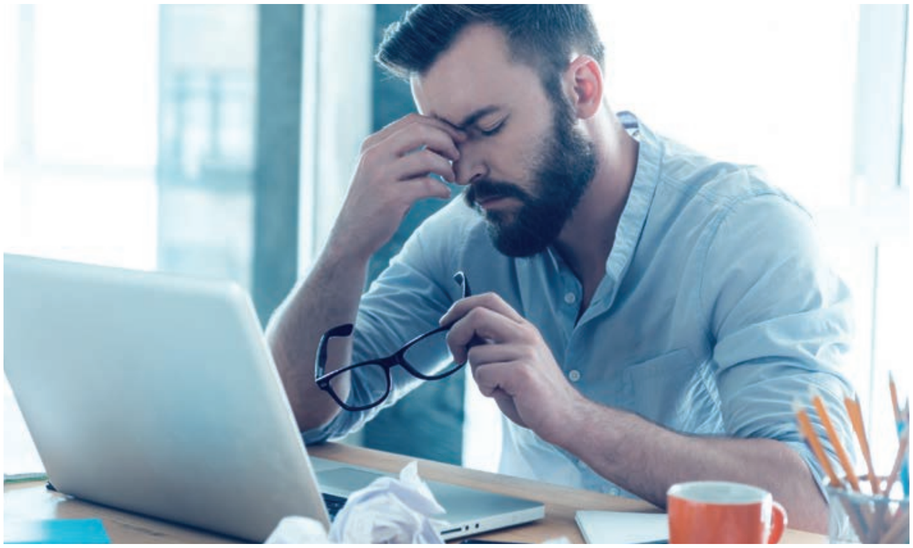
Economic uncertainty persists in many parts of the country. In the first quarter of 2016, the American Bankruptcy Institute reported that total commercial filings increased 24% from the year before. For businesses facing bankruptcy, valuation professionals can help determine whether liquidation or reorganization makes more sense, and provide guidance on everything from selling assets to shareholder disputes.

Evaluating Chapter 7 vs. Chapter 11

When should struggling business owners hire a valuation expert? The need for outside help typically arises after several years of financial losses, skipped loan payments, forgone salaries, maxed out credit lines and sleepless nights. A valuator who specializes in bankruptcies brings financial expertise and fresh perspectives to the table.

The first step is to establish a daily cash budget to regain control of cash. From there, a valuator can run financial scenarios to help assess which form of bankruptcy is more appropriate — Chapter 7 (liquidation) or Chapter 11 (reorganization). There might also be a third option: Take steps to avoid bankruptcy altogether.

The valuator can develop financial projections for several reorganization options, including best-, probable- and worst-case scenarios. He or she begins to assess a struggling company's financial strength and estimate the risk and probability of whether the business will go bankrupt.



Implementing an action plan

When liquidation value exceeds going concern value, most valuators recommend that the business consider filing for Chapter 7 bankruptcy protection. Liquidation value is often seen as a "floor" for a company's value.

Some businesses are actually insolvent, meaning they can't pay their debts. In such cases, a valuator might act as a court-appointed receiver and turnaround consultant who can facilitate the liquidation process — including winding down operations and paying out creditors in order of legal preference.

If, on the other hand, a Chapter 11 filing is deemed more appropriate, a valuator can help "sell" a reorganization strategy, such as debt forgiveness and restructuring, to lenders and other creditors. Many loans are overcollateralized. By appraising assets (including inventory, equipment and receivables), a valuator can help renegotiate working capital covenants. As debt terms are relaxed, it frees up cash.

Getting creative

Alternatively, a reorganization plan might call for divestitures of unprofitable segments to refocus on core operations. Or a distressed business might solicit offers to buy the company or its assets. A valuator can help find potential buyers and evaluate whether divestitures and offers appear reasonable.

When minority shareholders or creditors contest a transaction, the valuator can write a fairness opinion to help demonstrate that management exercised good judgment in analyzing a transaction. Fairness opinions are especially important when transactions involve related parties or if an executive's compensation package includes a "golden parachute" clause.

Staying level-headed

Another unfortunate side effect of financial distress is shareholder disputes. When management squabbles impair daily operations, owners may decide to split the assets — or one owner may choose to buy another's interest. In these cases, buyers tend to undervalue the business while sellers tend to overvalue it.

A valuator can help bridge the two sides by objectively estimating what the company and its underlying assets are worth. He or she also can help the parties identify assets that aren't on the balance sheet — including contingent legal and tax liabilities, customer lists, brand names, and business goodwill — and explain the tax implications of buyout terms, such as installment sales and earnouts.

Spending wisely

Businesses on the brink of bankruptcy may be hesitant to spend more money on outside professional fees. But valuators bring analytical skills, experience and objective insight to the situation. They can help overwhelmed owners crunch the numbers and consider all their options from a financial point of view, rather than an emotional one. ■

Is it time to switch to Subchapter S status?

No one can work forever, a fact that many Baby Boomers are starting to accept. As they face retirement, owners of C corporations who are contemplating a sale may be able to save substantial corporate-level taxes by electing to operate as a "pass-through" S corporation. Here's more about this tax break, including details on who might benefit.

Waiting out the recognition period

Subchapter S corporations offer numerous legal, financial and strategic benefits. One of the main upsides is that these entities generally aren't taxed at the corporate level. That is, income, losses and gains pass through to the owners' individual tax returns.

To avoid corporate-level taxes when selling assets or transferring equity, however, the company must have been an S corporation for at least five years. If a deal occurs before this recognition period ends, only the appreciation in value from the time of electing S status will escape double taxation — the "built-in" gain (gain that occurred while the company was a C corporation) will still incur corporate-level taxes.

The recognition period for built-in gain was recently shortened from ten years to five years under the Protecting Americans from Tax Hikes (PATH) Act of 2015. This change makes it easier for business owners to escape double taxation.

Owners considering selling all or part of their business should act now to save taxes later. The sooner S status is elected, the sooner you'll get through the recognition period. While there are strategies that may reduce the gain even if a sale occurs before the full recognition period is over, meeting the five-year requirement will eliminate the need to pursue the alternatives.

Recognizing potential pitfalls

Subchapter S status doesn't make sense for every business, however. For example, companies that are large enough to go public or be acquired by a publicly traded company might not benefit, because publicly traded companies don't qualify. S status is only granted to domestic, calendar-year companies with 100 or fewer shareholders. Partnerships, corporations, certain foreign individuals, and ineligible corporations can't participate in S corporations.

In addition, S corporations that pay distributions must make pro rata payments based on each owner's percentage of the business. And they can't have more than one class of stock.

Seeking professional input

Retiring Baby Boomers and other owners contemplating a sale should weigh the pros and cons of electing S status. If a newly elected S corporation transfers assets or equity before the recognition period ends, a valuation may be needed to establish value before and after the S election for tax purposes. A valuation professional can help take the guesswork out of these estimates and minimize the risk of IRS inquiry. ■