



# Marketability Discounts - 35%?

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# Marketability Discounts

- » **Market Evidence**
- » **Important Tax Court Cases**
- » **How Do You Handle It?**

# Sources of Market Evidence

## » Restricted Stock Studies

- SEC Institutional Investor Study - 1971
- Gelman - 1972
- Moroney - 1973
- Maher – 1976
- Trout – 1977
- Standard Research Consultants – 1983
- Silber – 1991
- FMV Opinions - 1994
- Management Planning – 1997

## » Pre-IPO Studies

- Emory - 1985
- Willamette Management Associates - 1996
- Valuation Advisors - 1999

# What are restricted stock studies?

- » Securities Exchange Act of 1933 generally requires registration of shares if they are to be sold
  - Intended to apply to underwriters or distributors of shares
- » Over the years, formal and informal guidelines about how unregistered shares could be sold developed
- » In 1972, those guidelines became SEC Rule 144
- » Restricted stock studies look at the difference in price between shares subject to Rule 144 restrictions and shares freely traded in the market

# SEC Rule 144

- » Goal to prevent creation of a market for shares of issuers about which adequate information unavailable to the market
- » Creates exemptions for sellers not involved underwriting or distribution of shares
- » Originally required a two year minimum holding period
- » Places volume restrictions on trading
- » Restricted shares generally subject to a two to three year minimum holding period

# Changes to Rule 144

- » 1997 – holding period changed from two years to one year
- » 2008 – holding period changed from one year to six months
- » Restricted stock studies used by appraisers generally consider only pre-1997 transactions

# Criticisms of Restricted Stock Studies

- » The companies are public and therefore are fundamentally different from small private companies
- » The owners of restricted stock know that there will be a market for the shares in the future
- » There is a known value for the marketable shares

# What are Pre-IPO Studies?

- » Measure difference in price between transactions in the time leading up to an IPO and the ultimate IPO price
  - Transaction at \$5 prior to IPO
  - IPO at \$10
  - Pre-IPO discount 50%

# The Emory (Baird) Studies

- » John Emory was the first to relate discounts on shares sold prior to IPOs to marketability discounts
  - First published in 1985 and updated periodically
  - Includes only transactions with affiliated parties
  - Includes only transactions in which Emory's firm (Robert W. Baird & Company) was involved

# The Willamette Studies

- » Look at a much larger sample of transactions
  - Sampled all IPOs, not just Baird IPOs
  - Transactions included non-affiliates as well as affiliates
  - Transactions went back 36 months (rather than 5 months)
- » Controlled for changes in industry index multiples between transaction date and IPO
- » Reached similar result

# Valuation Advisors Pre-IPO Study

- » Most commonly cited by appraisers
- » 2,300+ transactions searchable by size, industry, etc.
- » Subject to same criticisms as other pre-IPO studies
- » Similar measures of central tendency to the other studies

# Criticisms of Pre-IPO Studies

- » May measure items other than the marketability discount
  - New capital from the IPO itself may decrease risk or enhance growth prospects
  - The shares may also have been subject to Rule 144 restrictions
- » May suffer from selection bias (all the companies in the study went public)

# Marketability Discounts

- » Market Evidence
- » Important Tax Court Cases
- » How Do You Handle It?

# Marketability Discount Cases

- » Andrews
- » Berg
- » Mandelbaum
- » Cloutier
- » Weinberg
- » Janda

# Estate of Woodbury G. Andrews

## 79 TC 938

- » TC faults all involved for failing to recognize that discounts for lack of marketability and discounts for lack of control are “conceptually distinct discounts”

# Estate of Berg

## TC Memo 1991-279

- » Decedent owned 27% of Vaberg Properties, Inc., a real estate holding company
- » Parties stipulated the value of the underlying real estate
- » Taxpayer claimed a 60% discount citing previous cases
- » Expert for IRS testifies to a 20% minority interest discount and 10% DLOM – TC agrees
- » Often cited as a case where the TC found judicial precedent less enlightening than current facts and circumstances
- » TC assessed a penalty against the estate for underpayment of tax (later reversed)

# Mandelbaum TC Memo 1995-255

- » Big M owned women's clothing stores
- » Stipulated value on a marketable minority interest basis, so key issue was marketability discount
- » Unflattering treatment of expert reports
- » “We find incredible the proposition that any shareholder of Big M would be willing to sell his or her stock at such a large discount...”
- » Case lists “the Mandelbaum factors” to be considered in determining a marketability discount

# Mandelbaum Factors

1. Value of the subject's publicly traded securities, or, if there are none, the cost of a similar corporation's public and private stock
2. Analysis of financial statements
3. Dividend history and capacity
4. Factors relating to the company, its history, its industry, and the economy
5. Management
6. Degree of control transferred with the subject block
7. Restrictions on transfer
8. Holding period
9. Redemption policy
10. Costs of flotation

# Cloutier

## TC Memo 1996-49

- » Marketability discount for a controlling interest
- » Asset holding entity that owned a television station
- » Court makes a distinction between public and non-public companies for purposes of the guideline transactions method
- » Stipulated control value not based on the values of public companies
- » “...a discount for lack of marketability is inapplicable when the value of the unlisted stock is not determined by reference to the price of listed stock.”

# Weinberg TCM 2000-51

- » 25% interest in an apartment complex
- » IRS expert used the QMDM
- » “...we did not find the QMDM helpful in this case.”
- » “...slight variations in the assumptions used in the model produce dramatic differences in the results.”

# Janda

## TCM 2001-24

- » Nebraska bank holding company
- » Value on a control basis and 10% minority discount stipulated; DLOM only issue
- » Taxpayer's expert concludes 66% based on QMDM
- » IRS expert concludes 20% based on prior Tax Court cases
- » TC determines a 40% combined minority interest discount and DLOM

# Janda

- » TC expressed “grave doubts about the reliability of the QMDM to produce reasonable discounts, given the generated discount of over 65 percent.”
- » Some have used this case and Weinberg to argue that QMDM is not reliable

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# Marketability Discounts Group Discussion

- » Who is doing what to support DLOMs?
  - Do you use an income approach?
  - Do you use a market approach?
  - Do you cite the Tax Court cases? If so, do you attempt to relate the facts of your client to the cited cases?
- » What about controlling interests?

# Questions?

Thank you for your attention.

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