

Valuation Discounts for Holding Companies

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When evaluating an appraisal engagement there are generally two different types of companies: an operating company, which is in business primarily to derive profits through the offering of some product or service, or a holding company, which is usually established to derive profits primarily through the holding of assets for investment purposes. In certain situations where an operating company is asset-intensive or has operating income that is consistently less than the value of the assets that it holds, an appraiser will evaluate the company based more on the value of its assets than on the value of its operating income. For purposes of this article, the authors refer to all of these types of companies as “holding companies”.

Valuation discounts typically relate to either the lack of control or lack of marketability inherent in an equity interest. While these discounts are usually considered in many business appraisals, the determination of these values differs, sometimes significantly, depending upon whether a company is valued as an operating company or as a holding company. This article explores the valuation discounts that are generally applied in the appraisal of a holding company.

Valuation of holding companies

A holding company typically does not have ongoing operations other than the retention and management of assets in anticipation of future sale or trade. These assets often consist of cash, marketable securities, equipment, and real estate. The valuation of these companies usually relies significantly upon the asset approach, which estimates business value based upon the market value of the underlying assets rather than upon the income producing capacity of the company or the market values of similarly situated and comparable companies.

One of the typical appraisal methods under the asset approach involves determining net asset value, which can be represented as the market value of company assets net of liabilities. As might be expected, the type and nature of the assets, as well as the composition of the company’s total asset holdings, help to guide both the selection and quantification of applicable valuation discounts.

VALUATION DISCOUNTS APPLICABLE TO HOLDING COMPANIES

When valuing holding companies an appraiser will typically consider four basic types of discounts: a liquidation discount, a discount for lack of control, a discount for lack of marketability, and a cotenancy discount (which is also referred to as a discount for an undivided interest in real estate). Unless noted otherwise in the discussion that follows, the authors have assumed for all intents and purposes that the

valuation discounts discussed herein are within the context of appraising a holding company rather than an operating company.

Liquidation Discount

A liquidation discount considers the anticipated costs to liquidate a particular asset. A prime example of a cost to liquidate would be the broker or agent commission required to sell a piece of real estate or equipment. A potential buyer, assessing overall business value from the standpoint of the value of a company's individual assets, would appropriately consider the value actually obtainable upon an orderly or fire-sale liquidation of the underlying property. If these costs are not taken into consideration, the ultimate price paid for the company or its assets would likely be higher than otherwise warranted.

Liquidation discounts are asset-specific and must be considered on the basis of individual assets. For example, the liquidation discount for real property might be six percent, based on prevailing real estate commission rates, whereas a liquidation discount for marketable securities would likely be much less, since marketable securities would conceivably incur little to no transactional costs upon liquidation.

Other considerations in developing a liquidation discount might include legal fees, the ability to force liquidation¹, and contingent liabilities. By way of example, even if the subject of an appraisal lends itself to a valuation using the asset approach, a material and indeterminable lawsuit involving the company may present such a contingency that the future realizable value of the company's assets are highly speculative and significantly less than their current book or market value. A prudent buyer would consider this factor when determining the amount to offer for the company and would thus inherently apply a discount that considers how much of the current value would actually be retained into the future.

Discount for Lack of Control

The use of the asset approach in determining business value usually results in a value that reflects a controlling interest in the company, since the approach assumes that to receive the value of the assets one must be able to execute an order to liquidate and receive value for the assets. For equity interests that are not actually imbued with this level of control, some adjustment must be made to account for the fact that a prudent buyer would not be able to manage the assets or control investment decisions. This adjustment is typically made in the form of a discount for lack of control, which is calculated based upon a predetermined control premium using the following formula:

$$\text{Discount for Lack of Control} = 1 - 1 / (1 + \text{Control Premium})$$

¹ While this consideration may alternatively be evaluated when deriving a discount for lack of control, in the example above the authors envision a scenario wherein it might be appropriate as a factor in the determination of a liquidation discount. One situation might be where a protracted legal battle forces a company into liquidation.

The control premium used in the calculation above is derived from various sources, including the studies conducted by HLHZ and Mergerstat. While the appraiser must base the control premium estimate on objective evidence, such as the studies, there are also subjective elements that deserve consideration. These subjective elements are generally evaluated based upon the appraisers' experience and their interpretation of any rights of control invested in the appraised equity interest. Since a control premium incorporates the benefits of control, by necessity the formula above estimates the detriments associated with a lack of control.

Discount for Lack of Marketability

A discount for lack of marketability is used to compensate for the difficulty of selling shares of stock that are not traded on a public stock exchange, compared with those that are publicly traded. A discount for lack of marketability may also be appropriate when shares have either legal or contractual restrictions placed upon them, such as in the case of restricted stock, buy-sell agreements, and bank loan restrictions. While some practitioners argue that a discount for lack of marketability should be applied to a controlling interest to account for the holding period necessary to sell the equity interest, other practitioners argue that these anticipated costs should be incorporated elsewhere, while still others reason that no such discount should be taken since the controlling interest has the ability to effect the timing of the equity sale.

Data relating to discounts for lack of marketability can be obtained from various sources, although the most-widely used sources are restricted stock studies and pre-IPO studies. Because of the complexity and multiple considerations that must be made in determining a discount for lack of marketability, the authors have not addressed the topic in any great depth in this article. Rather, the authors reference specific considerations that must be made in determining the amount of the discount for lack of marketability.

As with the discount for lack of control, which considers by its nature the elements of control inherent in the appraised equity interest, the discount for lack of marketability is dependent upon the marketability of a specific equity interest. While there are many factors that impact the ability to market an equity interest, the most common considerations include the composition of the assets held by the company, the profitability of the company's operations, and the ability of the equity interest-holder to receive returns on or of their investment, whether by way of regular dividends or through the sale of their proportional equity interest after a period of appreciation in business value.

To appropriately determine a discount for lack of marketability that correlates to the appraised equity interest, the appraiser must compare the characteristics of the appraised nonmarketable equity interest to the characteristics of benchmark equity interests that are similar in all other respects except for the fact that they are marketable, or freely traded. An appraised equity interest that has more restrictions than the benchmark equity interests would be expected to require a higher discount for lack of marketability, with the opposite also being true.

Cotenancy Discount (Discount for Undivided Interest in Real Estate)

A cotenancy discount is applicable in relatively specific instances where the appraised equity interest owns an undivided interest in real estate. Given the many considerations inherent in assessing this discount, the authors will not address it in any great detail within this article. Rather, the authors wish to convey that this discount entails analyses similar to those conducted for the other discounts previously discussed with the only difference being that it is only applicable to an undivided interest in real estate.

APPLICATION OF VALUATION DISCOUNTS

One of the more common mistakes in the application of valuation discounts to holding companies is made when the appraiser applies the relevant discounts out of their proper sequence. Assuming that all four discounts are applicable to a particular appraisal, they should be applied in the order demonstrated below:

- Net Asset Value Prior to Cotenancy Discount
- (-) Cotenancy discount (a percent off a specific real estate asset)
Net Asset Value
- (-) Liquidation discount (either an actual cost amount or a percent of Net Asset Value)
Value of a 100 Percent Controlling, Marketable Interest
- (-) Discount for Lack of Control (a percent of the Controlling, Marketable Interest Value)
Value of a 100 Percent Noncontrolling, Marketable Interest
- (-) Discount for Lack of Marketability (a percent of the Noncontrolling, Marketable Interest Value)
= Value of a 100 Percent Noncontrolling, Nonmarketable Interest

If any of the discounts above are not applicable to the appraised equity interest they can be ignored, although the order of the remaining discounts should not change.

CONCLUSIONS

There are various types of discounts that are applicable to holding companies. The appraiser must have a thorough understanding of the company, its purpose and operational composition, and the equity rights attributed to its interest holders in order to apply the appropriate discounts and determine a reasonable estimate of value for a company.