AMERICAN SOCIETY OF APPRAISERS

Procedural Guidelines

PG-2 – Valuation of Partial Ownership Interests

I. Preamble

A. Business valuation professionals are frequently engaged as independent financial appraisers for purposes of valuing fractional or partial ownership interests. To preserve and enhance the quality of the services of such appraisers, the American Society of Appraisers, through its Business Valuation Committee, has adopted this Procedural Guideline.

B. This Procedural Guideline incorporates, where appropriate, all relevant Business Valuation Standards and Statements on Standards adopted by the American Society of Appraisers through its Business Valuation Committee.

C. The purpose of this Procedural Guideline is to define and describe the considerations and procedures that may be used in valuing partial ownership interests in businesses, securities or other fractional interests in tangible or intangible property. It is not binding.

D. Deviations from this Procedural Guideline are not designed to be or intended to be the basis of any civil liability, and should not create any presumption or evidence that a legal duty has been breached, or create any special relationship between the appraiser and any other person.

II. General principles

A. Partial ownership interests are interests of an enterprise or an asset of less than 100 percent. Partial ownership interests may exist in various business entities and assets such as corporations, limited liability companies, partnerships, and as direct fractional ownership of certain tangible and intangible assets.

B. Partial ownership interests comprise a spectrum of positions, from nearly total control (e.g., a 95 percent stock ownership position in a corporation, or the sole general partner of a limited partnership) to almost complete lack of control (e.g., a small block of non-voting corporate stock).

C. It is not possible to categorize partial interests in simple terms.

1. Generally, a partial ownership position in an entity or asset that is less than 50 percent may be classified as a noncontrolling or minority interest. Similarly, an interest of greater than 50 percent often confers control. An exact 50 percent interest may have both control characteristics (such as blocking power) and lack of control characteristics (such as inability to proactively cause an action to be taken).

2. The degree of ownership does not always indicate the degree of control.

a. Governance documents, loan covenants, securities attributes (e.g., preferences, voting versus non-voting, etc.) and other factors may confer control of an entity even if the interest at issue is less than 50 percent.

b. A 60 percent limited partner may have no control over a partnership if removal of the general partner requires a two-thirds majority vote of the limited partnership interests.

c. A 2 percent ownership position might be in a position of limited control if there are two other owners of 49 percent each who are at odds with one another. The same 2 percent owner would be in a completely different position if there was only one other owner of 98 percent, or 49 other owners each owning 2 percent.

d. Three interests of one-third (33 1/3 percent) each provides yet another set of potential valuation dynamics.

3. A complete listing of all the different potential combinations and permutations of ownership structure and characteristics is beyond the scope of this Procedural Guideline.

D. Development of value for a partial interest can be a very different process from valuing the underlying entity or asset as a whole. In addition, valuation of partial interests may or may not be a direct function of the value of the underlying entity or asset as a whole.

1. It is the responsibility of the appraiser to determine if valuation of the underlying asset(s) or entity as a whole is required in order to develop credible appraisal results for the partial interest.

2. If ownership of a partial interest does not provide the ability to liquidate an entity, cause its sale or gain access to any of the assets, valuation of the whole may not be relevant to the analysis. However, if investors or market participants would nonetheless consider the value of the whole irrespective of their inability to cause liquidation or sale of the entity or assets, then valuation of the whole, either on a going concern or liquidation premise, may be appropriate to consider in the analysis.

3. If ownership of a partial interest does provide the ability to cause liquidation of the underlying entity or sale of the underlying asset, and value of the entity or asset depends primarily on the asset-based approach, it may be appropriate to obtain qualified appraisals of any real estate or personal property.

E. Valuation of partial ownership interests is often dependent on contractual provisions. Consequently, rights and restrictions contained in documents such as articles of incorporation, bylaws, partnership agreements, tenant-in-common agreements, option agreements, buy-sell agreements or shareholder agreements may be relevant to the analysis. Similarly, value may be a direct or indirect function of applicable laws and regulations.

F. Appraisers should be aware that the standard (type) and premise of value can have a material effect on the value of a partial ownership interest. For example, valuation of a minority shareholding under the “fair value” standard of value may be very different from its value under the “fair market value” standard of value.

III. Factors to consider

A number of factors may be appropriate to consider in valuing partial ownership interests. The following list is not intended to be all-inclusive. Items on the list may or may not be applicable in specific valuation situations.

A. The purpose and definition of the valuation engagement in accordance with BVS–I General Requirements for Developing a Business Valuation, including the applicable standard (type) and premise of value.

B. Factors related to the underlying enterprise or asset, including:

   1. The value of the underlying enterprise or asset, if applicable.

   2. Enterprise-level or asset-level tax effects, if relevant.

C. Factors related to the subject partial interest, including:

   1. Provisions in the organizational and governance documents that affect the rights, restrictions, marketability and liquidity of the subject interest. Documents to consider may include partnership agreements, articles of incorporation, bylaws, operating agreements, buy-sell agreements, investment letter stock restrictions, option agreements, lock-up requirements or others that may be relevant.

   2. Applicable laws and regulations. Business examples include statutory rights to demand dissolution of a corporation under state law, restrictions on transfer pursuant to SEC Rule 144, and many others. An asset example is included the right to partition.

   3. The existing ownership structure and configuration.

   4. Access to, availability of, and reliability of information regarding the underlying asset or entity.

   5. The relevant pool of potential buyers, if any.

   6. Market data on transactions in similar markets, if any. Potentially similar markets might include private placements in publicly or privately syndicated entities (including restricted stock transactions, pre-IPO transactions, and transactions in publicly traded limited partnerships) or tenants-in-common arrangements, etc.

   7. Expected holding period for an investment in the subject interest, including consideration of such factors as:

      a. The extent to which the expected holding period may be uncertain.

      b. Defined expiration or termination dates contained in the governing documents, or other external factors, that may precipitate a foreseeable liquidation or sale of the underlying entity.

      c. Analysis of the age, health and other characteristics of the other owners and/or key managers, which could provide information about the possible timing of a sale or liquidation by the controlling owner(s).

      d. The history of transactions (if any) involving partial (or possibly controlling) interests of the subject enterprise or asset, including recapitalizations or stock repurchases that have provided liquidity to shareholders.

e. The potential market for similar enterprises or assets (e.g., is the industry consolidating?).

f. The emerging attractiveness of the entity for equity offering, sale, merger or acquisition.

g. Provisions in the governing documents or buy-sell agreements, or under law or regulation either prohibiting, restricting or allowing transfer of the subject interest.

h. Rights and powers attributable to the subject interest that may enable a sale of the subject entity, asset or the interest itself, against the will of the other owners.

i. Historical actions of management and/or the directorate, which may provide information about their policy and intentions regarding eventual sale of the entity or asset, or receptivity to a potential sale or repurchase of partial interests.

j. The existence, depth and functioning of markets that might be available for interests similar to the subject interest.

k. The appropriateness of considering a range of expected holding periods and exit possibilities.

8. Expected economic benefits associated with the subject interest, which come in the form of interim benefits (dividends or distributions) and a terminal cash flow when the investment is sold or liquidated.

a. Expected interim dividends or distributions to the interest, which may differ from the expected benefits (cash flows) generated by the entity or asset as a whole. Interest-level benefits may be affected by such factors as:

(1) The history of dividends or distributions, including both timing and amounts.

(2) Current or expected future distribution policy.

(3) Preferential dividend claims.

(4) Enterprise-level and/or interest-level tax characteristics.

(5) The outlook for one-time and/or irregular dividends or distributions.

(6) Circumstances with controlling owners that may increase (or decrease) the likelihood of future interim benefits.

b. The expected terminal cash flow at the end of the expected holding period(s), which may be a function of such factors as:

(1) Possible future transactions involving the enterprise or asset as a whole, or transactions in the subject interest itself.

(2) Current (valuation date) value and expected growth in value of the enterprise or asset to the end of the expected holding period(s).

(3) Growth in value may be a function of expected earnings retention (distribution policy) and the amount of and effectiveness of expected reinvestment in the entity or asset.

9. Required return for investing in the subject interest. The required return may consider risks other than risks related to the enterprise or asset as a whole, including for example:

    a. The expected length and uncertainty of the holding period.

    b. The likelihood of dividends or distributions (i.e., expected distribution policy).

    c. The costs of due diligence efforts required to acquire the subject partial interest.

    d. The costs of monitoring the investment over the expected holding period, including issues related to the expected receipt of timely and reliable information concerning the investment.

    e. Required returns on similar investments or investments with similar investment-specific liquidity and holding period characteristics.

    f. The risk of tax liabilities from pass-through profits without guaranteed tax distributions in entities such as limited liability companies, Subchapter S corporations or partnerships.

    g. The difficulty and cost of marketing the subject interest.

    h. The risk of involuntary dilution when no preemptive rights are provided in the articles of incorporation or bylaws of a corporation.

    i. The degree of control conveyed by the subject interest.

10. Ownership-level tax effects, if relevant.

11. Prior transactions in the subject interest, entity or asset, and their relevance to a given assignment.

D. Interaction of the factors listed above, and their cumulative impact on the degree of control, marketability and liquidity of the subject interest.

IV. Approaches, methods and procedures

A. Appraisers should consider all three approaches to value (asset-based, income and market) when valuing partial interests. If an approach is excluded in an assignment the appraiser should explain the reason for such exclusion in the appraisal report.

B. It may be appropriate for the appraiser to obtain the assistance of legal counsel in order to gain a reasonable familiarity and understanding of the legal and regulatory environment that may influence or affect value. Similarly, it may be appropriate for the appraiser to obtain input from counsel regarding governing documents and agreements.

C. If discounts or premiums are applied at the partial ownership level the appraiser should explain how the discounts or premiums were developed, as required by BVS–VII Valuation Discounts and Premiums.

D. If the income approach is used at the partial ownership level the appraiser should develop and support any assumptions concerning the expected benefits to be received, the expected or required holding period(s) and the appropriate required rate of return on the investment given the risks associated with the subject ownership position. To the extent applicable the provisions of BVS-IV Income Approach to Business Valuation should be followed.

E. If the market approach is used at the partial ownership interest level, several other sections of the Standards may be applicable.

1. Discounts for lack of marketability (or discount rates) are sometimes developed, for example, by reference to or analysis of restricted stocks of public companies, options on public securities (such as long-term equity anticipation securities), pre-IPO transactions in private companies that later went public, or other public securities. When using such methods, the appraiser should follow the guidance of SBVS-I Guideline Public Company Method as well as BVS-V Market Approach to Business Valuation and BVS-VII Valuation Discounts and Premiums.

2. Similarly, appraisers using studies of transactions in the secondary market for private partnership interests to develop discounts for lack of marketability (or discount rates) should follow the guidance of SBVS-II Guideline Transactions Method, as well as BVS-V and BVS-VII.

3. If transactional premium studies involving public companies (e.g., control premium studies) are utilized by the appraiser to support discounts for lack of control (minority discounts), the provisions of SBVS-I and BVS-VII should also be applied.

F. When reconciling the final value conclusion for a partial interest, regardless of the method(s) employed, the appraiser may wish to consider one or more tests of reasonableness for the concluded value of the partial interest, such as:

1. Calculating the implied internal rate of return for the subject interest at the concluded price over the relevant range of expected holding periods, and comparing the implied internal rate of return to expected returns of similar investments, if available.

2. Calculating the implied dividend or distribution yield for the investment based on the expected dividend or distribution policy of the enterprise, and comparing the implied dividend or distribution yield with expected yields on similar investments, if available.