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A Tale of Two Markets

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Introduction

I was wrong. In my June, 1990 Business Valuation Review article (*"Control Premiums and Minority Interest Discounts in Private Companies"*) I asserted that public companies tend to trade at or near their control values. Of course, promptly after the article was published the markets turned upside down, with public companies trading well above what they would sell for in the M&A market.

As could be expected there were several responses to my article. These came from Z. Christopher Mercer, Michael J. Bolotsky, and Dr. Wayne Jankowske. Although the evolution of thought in these responses came almost full circle back to my original position, and I thought the argument had prevailed, we continue to be bedeviled by this "Levels of Value" chart which keeps popping up, as if from the dead, which shows three levels of value, i.e.; "non-marketable minority interest" value, a "marketable minority interest" value, and a "controlling interest" value. The most recent visitation by this apparition was in Mr. Mercer's article *"Should "Marketability Discounts" be Applied to Controlling Interests of Private Companies?"* (BVR, June, 1994, page 55).

Despite my deep respect for Chris Mercer, I must strongly disagree with the concepts embedded in the "Levels of Value" chart. Let me therefore try once again to make the case that such a chart, if generally applied, will tend to result in overvaluation of controlling interests as well as minority interests.

First, some "market color"

While we have been debating how many angels can dance on the head of a pin the markets have proven all of us wrong. For a variety of fundamental and technical reasons, the stock market in the last several years has inflated to extravagant valuations. Although it has come off a bit since January, the general consensus I observe seems to be that the market is still at historically high valuations when measured by price to earnings, price to book, dividend yield, etc.

Since my last article, financial "raiders" of public companies have gone into hibernation (although we have seen some renewed activity recently as lenders have become more aggressive). At the same time sellers of small-to-medium-sized companies have had a hard time adjusting to the decline in values that most financial buyers, and many strategic buyers, are willing to pay for whole businesses.

In fact, I have read a number of articles in the last three years, and interviewed investment bankers who have corroborated cases, where owners have decided at the last minute to sell their business for a lower price to a private buyer rather than go through the agony of the IPO process where they could obtain a much higher price. The IPO versus M&A sale is not strictly comparable, of course, since it is not possible for owners to cash out 100% in an IPO as they can in a private sale. However, the fact that the IPO would have given the owners a higher valuation than the private sale is indicative of my point.

As we have seen in the last several years, going-private transactions have been few and far between, while initial public offerings have been flooding into the public's hands. It seems to me that this extreme imbalance, between companies getting into the public market versus those getting out, is further evidence that the public market has recently been more highly valued than the M&A market.

Additional confirmation that the public markets have generally been trading at or above the value of the mergers and acquisitions market comes from the valuations we all do. Select just about any assignment you have had recently and compare the multiples of the public stocks against the multiples of similar controlling interest M&A transactions. If your experience has been like mine, transactions involving whole companies, even including many strategic acquisitions, almost invariably have multiples that are equal to or less than those of guideline public companies.

Anyone who has attended ASA's conferences in the last couple of years will understand why this may be. As we have heard time and again, buyers of whole companies generally have equity rates of return requirements in the 20% to 50% range. (And guess what? Unless you are a large public company acquiring another public company, you don't get your rate of return requirement using the Capital Asset Pricing Model!)

Acquisition equity rates of 20% to 50% are backed up by articles in a variety of publications, including Mergers and Acquisitions magazine and Corporate Finance magazine. My discussions with M&A dealmakers indicate that financial buyers are **still** typically looking for deals with enterprise values in the four to six times EBIT range; a multiple, by the way, which is derived assuming generous helpings of acquisition debt.

My understanding is that public investors have much lower rate of return expectations than 20% to 50%. A lower overall rate of return requirement will clearly translate into higher values for public equities. That the public market has been trading above the M&A market **in general** is, I believe, self-evident to anyone who seriously monitors the markets. I will therefore not belabor the issue further.

Two separate markets

These recent market changes have thrown into sharp relief the fact that the M&A market and the public market are separate and largely disconnected markets. They are each populated with buyers and sellers whose motivations and investment criteria are highly divergent. They do not operate in tandem. And there certainly isn't the static relationship which is implied in the "Levels of Value" chart.

Alas, this idea that the M&A and public markets are separate and independent is not original with me. Tony Leung imparted this insight to me shortly after the publication of my first article. I am sure many readers have had the thought or discussed it privately for some years. During the 1993 ASA **Advanced Business Valuation Conference** in Conroe, Texas, Mark Lee, a managing director of Bear, Stearns stated matter-of-factly that this was the case. I am not sure if he was aware of how novel this concept might be to certain segments of the ASA and what the idea implies for rewriting the textbooks and reorganizing the Level Courses offered by our Society.

Proposal for a new valuation perspective

Every valuation I do begins with the assumption that the company is 100% owned by one person who is interested in maximizing the value of the business as of the valuation date. Thus, the project starts with an analysis of the options available to the 100% controlling owner.

For large companies, the controlling owner has three possible ways to maximize value: go public, sell the business, or liquidate. Whichever of these three options yields the highest value I consider to be the fair market value of the enterprise to the 100% controlling shareholder. Let's not worry too much about the fact that the "going-public" option cannot bring the owner 100% cash as quickly as the other two options can. The owner still owns the stock he or she didn't sell in the IPO and should have the opportunity to sell it in secondary offerings over a period of one to four years, possibly at appreciated prices.

For a small company, or one which does not have the necessary characteristics to be a public company, the owner is reduced to two options: sell the business or liquidate. In this case, the value relationship between the subject and guideline public companies would appear to be largely moot since public market values are not available to the 100% controlling owner. However, even the smallest company may be sold in the M&A or business brokerage market, so this market will almost always be a benchmark, although my previous admonitions about relying too much on individual deals as yardsticks still applies.

Of course, the going concern values (public market and M&A market values) must also be compared to value in a liquidation, which is always an option for a 100% controlling owner.

The point is, whether it be a sale to the public in tiny pieces, a sale of the whole in the M&A market, or a liquidation of the business, the approach which yields the highest value is logically the fair market value from the perspective of the 100% controlling owner. (And, no, you don't get the M&A market value by adding a control premium to the public market value. You get it by looking at valuation ratios of actual deals, by talking to investment bankers and business brokers, by reading Mergers and Acquisitions magazine, etc., and by attending ASA conferences which focus on real-world buyers and sellers of companies.)

What are the implications for valuing a minority interest under this new approach?

By beginning with the assumption that the fair market value of the subject company is the maximum value available to a 100% controlling owner, it follows that discounts for both lack of control and lack of liquidity could then be applied in determining fair market value of the minority interest. After all, the minority interest holder has no ability to force access to any such maximized value, even if maximum value comes from the public stock market. With no ability to access maximum value, no control over the operations of the business, and zero or nominal liquidity available to the minority shareholder it seems logical that both discounts would be applicable, irrespective of how the 100% control position is valued.

Principal problems with this approach

1. No capital market evidence of the value of control in private companies

One of the principal problems with this approach is that we have no reliable capital market benchmark upon which to base the detriment to value caused by lack of control in a private company. The public company "control" premium reciprocal is unacceptable because, as I discussed in my speech at the 1991 ASA **Advanced Business Valuation Conference** in Phoenix, Arizona, the meaning and value of control is utterly different between public minority shareholders and private minority shareholders:

1. The fact that public stocks are liquid makes control a non-issue for public shareholders, except in a purely economic sense. "Control" *per se* becomes important to the public shareholder when a transfer of control means being able to sell for a quick profit or to liquidate a position before a stock declines further. This leads to the realization that, absent frenzied bidding, acquirors of public companies generally need only pay a modest premium over market to bribe public shareholders into selling. This may be why the Houlihan Lokey and Mergerstat takeover premium studies tend to show such consistent averages, regardless of whether the Dow is at 1,000 or 3,500, is declining or ascending.
2. On the other hand, for equity holders in private concerns, lack of control can be emotionally and qualitatively very different. Control of private companies is often of principal importance. Minority positions, on the other hand, are avoided if at all possible. Yale Kramer, in

his essay *"Perspectives on Valuing a Minority Interest in a Private Company"* in the Handbook of Business Valuation (edited by Thomas L. West and Jeffrey D. Jones) described the minority position in a private company as being one of "a dog lying prone with its tail between its legs while the victor stands over the vanquished". Public shareholders have none of these concerns because they have the ability to sell.

In addition to the fact that the meaning of "control" is fundamentally different between the two types of minority shareholders, public company "control premiums" are affected by much more than just the issue of control. Factors such as strategic synergies, foreign exchange cross rates, supply and demand for companies, the heat of the auction, type and availability of financing, mistakes, anomalies, ego, greed, tax effects, regulatory factors, bad advisors, etc., etc. all become part of the takeover process and are incorporated into what a buyer will pay for a public company. Premiums which may be paid for public companies should really be called "transaction premiums" rather than the misleading term "control premiums".

Establishing relevant capital market evidence regarding the value of control in private companies is one of the few remaining areas of virgin territory in the business valuation field. Perhaps Dr. Jankowske or others in the academic world could persuade some graduate students to design a thesis project which would explore this issue and begin to quantify those factors which increase or decrease the value of control in a private company (see David W. Simpson's article *"Minority Interest And Marketability Discounts: A Perspective"* in the March, 1991 BVR, page 7, for a good starting point in analyzing some of the qualitative factors of a minority discount).

2. *Possible difficulty determining which companies could go public*

One of the more interesting challenges of this proposed valuation perspective is determining whether or not a subject private company could truly have access to the public market, which would then make a comparison with public stocks relevant. Although many of the companies we deal with could not be public, it does occur from time to time that the subject is a reasonable candidate for an IPO. The following are some initial thoughts on this subject:

1. It seems there can be no asset or revenue test for determining which companies could, or could not, go public. To give two extreme examples of why this is an area for informed judgment: **3DO**, a start-up multimedia venture, had no sales and an accumulated deficit in the millions when it went public in 1993. On the other hand, Corporate Finance magazine (Fall, 1993, page 26) believes that **American Standard**, with $3.8 billion in sales, does not have the option of going public because it is so highly leveraged.
2. The last few years have been a huge bull market for IPOs and we now have available a much wider range of potential guideline companies. The criteria for determining whether or not a company is a reasonable candidate for an IPO may be broader and more flexible now than in the past. However, it is axiomatic that the criteria will change (sometimes rapidly) over time.
3. There are grey areas. Companies which fall somewhat below the size range that would allow them to be taken public might still yield to a public guideline analysis through some of the size-level extrapolations suggested by Jerry O. Peters - (*"Adjusting Price/Earnings Ratios for Differences in Company Size - An Update"*; BVR June, 1993). Also, companies which could not go public now, but are planning to go public in a year or two, might also be a special case. Such companies may be moving in the direction of liquidity and might be susceptible to a public company analysis.
4. Finally, there are the inevitable situations where a company could not possibly go public, yet there exist several similar companies in the public market of about the same size as the

subject. Perhaps the public companies were at one time much larger but may soon be delisted. Perhaps they were able to sneak through a window ten years ago. Strictly speaking, from the perspective of the options of the subject company's 100% controlling owner, the public guideline companies may have no relevance; however, depending on the nature of the project, it may still make sense to consider the public stock data.

Clarifications

Because the ideas in this and in my previous article are slightly provocative, supporters and detractors may read into them what they want to believe. To avoid confusion as much as possible, let's be specific (or redundant, as the case may be):

1. I am not saying that the public market price represents a control value *per se*. It is undeniable that public shares trade as minority interests. However, the fact that the public market is liquid frees public shareholders from worries about the fact that they do not control the companies in their portfolios. By being able to ignore extraneous "lack of control" issues, public shareholders are able to bid prices up to the underlying economics of a business, which is what a typically-motivated controlling-interest financial buyer would also focus on.
2. I am not saying that the "Levels of Value" chart is always wrong. Certain industries at certain times may conform to the model. However, I personally have yet to perform an appraisal where I have observed a measurable discount in the multiples for publicly-traded stocks as compared to similar guideline controlling interest transactions.
3. I am not saying that public companies do not get acquired for a premium over their previous trading price. Premiums are self-evident. What I am saying is that these are rare circumstances and do not represent the vast majority of public companies. In any case, the premiums are not the relevant factor to look at. The multiples are. Compare M&A multiples with similar public company multiples and ignore the premiums.
4. I am not saying that public company transaction premiums have no element of control in them. But the premiums are muddied up with so many other things it is impossible to distill out the control aspect. And, since "control" for private company shareholders has a different meaning than it does for public shareholders, even if we could distill the control aspect out of the premium it would not be applicable to the companies with which we work.
5. I am not saying that guideline M&A deals which are strategic in nature cannot form the basis for a fair market value determination. Clearly, in certain consolidating industries where strategic combinations have occurred and are expected to continue in the future, a selling owner might have every expectation of being able to access the values being evidenced in the market.
6. I am not saying that starting with the 100% control value and taking double discounts is the **only** way to value a minority interest. Certainly, cross-checking the value through capitalizing earnings and dividends, or researching the private equity markets to see how the minority interest might be viewed by potential investors in the real world, is a wise idea.

Conclusion

The last couple of years have shown that the public market and the M&A (or business brokerage) market are really two separate and generally unrelated markets. Their investor populations are different, the rules of the markets are different and their valuation principals are different. Only rarely do the two markets intersect in the purchase of a public company, and when they do the premiums which may be paid have little relevance for the business appraiser unless he or she is working on the purchase or sale of a public company.

Based on the reality of two separate markets I have proposed in this article a new valuation perspective which will allow us to systematically estimate the fair market value of a controlling interest in a business by analyzing the strategy which would provide the highest value to a 100% controlling shareholder. If minority interest value is the goal of the assignment, this controlling interest value will then be adjusted with discounts for lack of control and lack of liquidity (and possibly for Bolotsky's other factors as well), even if maximum controlling interest value is derived from comparison with the public market.

The approach I propose frees us from the artificial and academic confines of the "Levels of Value" chart and allows us to conform our work more closely with the way investors in the real world think and behave. This can only lead to a more practical, realistic and useful way of appraising both controlling interests and minority interests in closely-held businesses.

In order to better understand the impairment to value which results from the lack of control in a private company we need new research that will help us quantify the value of control in such companies. The information we now have in the form of transaction premiums paid for public companies gives us no useful information in this regard.

I am not unmindful of how "shifting the paradigm" may be uncomfortable or inconvenient for some members of the ASA. But our business and the science of the markets is still evolving. The books and courses don't have all the answers and there continue to be substantial opportunities for new understanding in our field. It seems better to me to put aside the models and charts which once seemed reasonable but which no longer work than to continue trying to rationalize an untenable position.

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