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Views on Control Premiums

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Many valuation analysts believe that public company stocks trade at a “marketable noncontrolling”, or “marketable minority” interest level of value. In my opinion, this is simply not true. Public stocks *are* non-controlling interests, *but they do not trade as if they are*

One of the simplest ways to test this assertion is as follows. Next time you are buying or selling public stocks, stop and ask yourself if you have adequately discounted the price because you personally were not able to appoint management, change the board of directors, set operational or strategic policy, change the course of the business, liquidate, dissolve, sell out, etc., etc., etc. This basic mental exercise should suffice to illustrate how ludicrous it is to regard publicly-traded guideline company prices as reflecting “marketable minority” or “non-controlling” levels of value. Public stocks trade at public market prices, and those prices have *nothing* to do with each share’s lack of control (with perhaps a few outlier exceptions).

If public shares are noncontrolling minority interests, but aren't priced in the market as noncontrolling minority interests, how can this be?

Reflecting back on our experience investing in the public market, the obvious first answer is that there's no need to worry about this because the liquidity of our shares gives us complete control over our investments. We can buy or sell whenever we want and no one can stop us. The process of converting a private company into a

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public company (via IPO) essentially represents a quantum transformation of the investment. One day you are a private company minority owner with no control over the company and no control over your investment, the next day you can buy more or sell your entire position (assuming you are not subject to Rule 144, obviously). Control over the investment is created in the IPO process, and that is all that is required to eliminate any "discount for lack of control".

Not only do public shareholders have total control over their investment, but the beauty of the public market also means that shareholders are relieved of the responsibility of having to exercise management control. All those "prerogatives of control" listed in the valuation literature would be chains around the neck of the public shareholder. One of the main reasons stock markets were invented in the first place was to intentionally outsource the traditional "prerogatives of control". In a way, public markets convey the blissful "prerogative of not having to control anything".

Not being required to control anything in the companies in which they invest, public shareholders are freed up to focus on more fundamental issues of cash flows and risks of the business itself rather than on the problems of being a minority owner. This is why public shares tend to trade at or near their "control", or "takeover" value and why the public market equivalent value for a private company equals a control level of value. In fact, my experience has been that the liquidity of the public market allows most listed companies to actually trade *above* their takeover value. (I have long suspected that the ability of individual investors to completely diversify their portfolios using mutual funds lowers their weighted average required rate of return to the point that overpaying for many individual public companies is almost inevitable. The effect of this overpayment becomes a systemic issue throughout the market rather than an individual company valuation issue.)

But, don't just take my word for it. To quote the Appraisal Foundation's current Working Group discussion draft on "*The Measurement and Application of Market Participant Acquisition Premiums*" (note that the title of this draft shouldincludethecaveatthatitisforfinancialreporting only):

> "There is no argument that the shares that transact in the public market are minority

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> interests. However, that does not mean that the price paid for them represents 'only' a minority value and that something more would be paid to gain control of that company."

Although the Appraisal Foundations' discussion draft on acquisition premiums comes to many wrong conclusions, its premises are promising, with many progressive observations. For example:

> "In any case, it has become relatively widely accepted that the market evidence supplied by dividing the acquisition price by the publicly traded price does not represent a premium for conceptual control but, rather, represents a premium paid linked to actual changes that can be made by exercising that control. Control, and whether one has it, is not really the focal point. What matters is that, after an acquisition, the acquired company is now under different management. A price higher than the publicly-traded price is reasonable if the new management and/or combined entity expect(s) improved cash flow or growth; or reduced risk. If no cash flow improvement or risk reduction could reasonably be expected, there is little reason for an acquirer to pay a price higher than the publicly-traded price. In such cases, the control value may approximate the publicly traded price. The Working Group believes that the economic benefits of control that support MPAPs (Market Participant Acquisition Premium) are ultimately manifest in two ways: enhanced cash flows or lower required returns."

Given all this, what then are these premiums being paid for public companies if not for control? After all, the buyer of a public company is gaining control over the acquired entity. So, why doesn't the premium paid quantify some differential between control and lack of control? Much has been written, listing all the reasons why it makes sense for premiums to be paid for public companies and why this does NOT quantify any differential between control and lack of control. Another analogy which illustrates the market dynamic between a control seller (i.e., the public company) and a control buyer:

> Suppose you own a house. You bought it many years ago and are very happy living there. It was

> recently appraised at $400,000 and that is exactly what it would sell for if you put it on the market. You have no intention of moving, however. Along comes a buyer who really likes your house. She is very motivated for her own reasons, and offers you $540,000, a 35% premium to its market value. You might or might not sell, but there will be some price at which you realize it makes financial sense to take the money and find another place to live. In a somewhat more complex way, this is the genesis of public company acquisition premiums. *In neither case are we dealing with lack of control issues.*

The Appraisal Foundation's discussion draft on Acquisition Premiums by the Working Group suggests converting the acquisition premium analysis from an equity basis to an enterprise basis to mitigate potential bias problems arising from the use of premiums on an equity basis only. Timothy Meinhart's editorial on November 6, 2012 (BV Success Issue 17-45) proposed the same type of solution. Analysis of premiums based on capital structure and enterprise value may represent some improvement over the traditional equity approach, particularly because buyers usually analyze acquisitions on an enterprise value basis. But merely converting the equity premium analysis to an enterprise premium analysis does not deal with the more fundamental conceptual shortcomings of the data and the overall theory.

Let's look at yet another reason why even an enterprise value approach to premiums fails: the upward bias of the acquisition/control premium databases, not from timing issues, selection bias or measurement problems, but because of mistakes.

A quick search reinforces what we already know: at least half of all M&A deals fail. In "The Big Idea: The New M&A Playbook" (Harvard Business Review, March 2011), Christensen, et al. state that "study after study puts the failure rate of mergers and acquisitions somewhere between 70% and 90%." The authors attribute this to buyers' misunderstanding of the true goal of M&A (i.e. to redirect the company into higher growth opportunities), compounded by the fact that "buyers too often pay the wrong price and integrate the acquisition in the wrong way." In other words, the vast majority of acquisitions are *mistakes*. If an acquisition is a mistake, then the buyer clearly overpaid for what they hoped would be a financially prudent deal. If the buyer overpaid, then the premium is *defacto* overstated regardless of whether it is calculated on an equity basis or an enterprise basis. Then, along comes the appraiser who relies on a so-called “control premium” database in which the majority of the premiums, because they were mistakes, are overstated. Overstated premium data means that the appraiser’s value conclusion will inevitably be overstated as well, irrespective of whether the appraiser uses the traditional equity method or the enterprise method. Added to all the other compelling reasons to avoid using acquisition/control premium data and methods (do the research if you are not familiar with these reasons), the systematic bias of the premiums due to overpaying in the majority of cases should be the final nail in the control-premium coffin.

Conclusion

Control premiums were hotly debated during the 1990s. By the beginning of the 21st Century it was generally recognized by ASA and most practitioners that the use of “control premiums” should be considered much more carefully and used with great caution, if at all. ASA’s educational offerings were intentionally updated in the 2000s to advise a default assumption to not use acquisition/control premiums unless a compelling case for them could be made. *(Editor’s note: While Mr. Nath’s representation regarding ASA’s course content is correct, the reader is reminded that ASA course content is non-authoritative.)* Application of a "control premium" to a publicly-traded equivalent indication of value for a private company or reporting unit, whether through the market approach or the income approach, will almost always overstate value and will therefore be misleading.

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