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# Valuing a minority interest: Have you considered all methods and factors?

There are four main approaches that can be used to value a minority interest.

In this article, we address the following:

- Provide a brief summary of each of the approaches and highlight their main advantages and disadvantages;
- Set out the factors you should consider when estimating the level of Discount for Lack of Marketability ("DLOM") of a minority interest (both factors that will increase and/or decrease the DLOM); and
- Explain how you would estimate the Discount for Lack of Control ("DLOC") of the minority interest.

## Valuation approaches

| Approach | Advantages / Disadvantages |
| --- | --- |
| **1. Value by comparison to previous arm's length transaction of minority interests, typically in the subject company being valued, or in comparable companies, if transaction information is available.** | The first point of call should always be to look at the previous transactions in the shares of the subject company. The previous transactions must meet the definition of fair market value (or the value definition stipulated in the Shareholder's Agreement if it is different i.e. fair value). This approach has the advantage of capturing both Discount for Lack of Marketability ("DLOM") and Discount for Lack of Control ("DLOC").<br><br>Often this is very good evidence of value. |
| **2. Estimate the control value for the subject company (using either the Market Approach and/or the Income Approach) and take explicit discounts for lack of control and lack of marketability from a pro rata control value for the subject company.** | This is subjective in that the valuer needs to determine the DLOC and DLOM, although these discounts can be supported with empirical evidence (see comments below).<br><br>Generally, depending on the size of the holding, it is preferable to use the minority interest income stream instead as in (3) below. |


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**3. Capitalise or discount the cash flow that is available to the minority interest holding, and apply a Discount for Lack of Marketability. The cash flow available to a minority interest is dividends, therefore you need to project the dividend payments from the forecasts in the near future and discount them based on dividend yields on guideline publicly listed companies, operating in the same industry, and which can be considered reasonably comparable to the subject company.**

The main advantage of this approach is that it does not require an explicit DLOC, because this discount is inherent in the cash-flow streams used in the valuation, which are minority interest cash flows. However, the disadvantage is that it assumes current policies will last in perpetuity (e.g. dividend distributions).

When estimating the DLOM, you should ensure that you consider all the factors (see below).

**4. Apply multiples derived from publicly listed companies for the minority income stream such as Net Profit After Tax and take a discount for lack of marketability.**

The main advantage is that it does not need an explicit DLOC, and is a well-established traditional practice. However discounts will be required for other differences to the subject company, including, but not limited, to the Discount for Lack of Marketability.

## Determining a Discount for Lack of Marketability ("DLOM")

Marketability is the ability to quickly convert property to cash at minimal cost. The DLOM is the amount or percentage deducted from the value of an ownership interest to reflect the relative absence of marketability.

If you value a company based on a Dividend Yield approach or using public company multiples for the minority income stream (NPAT), these represent a minority interest traded value. Thus, this value is one in an active trading market whereby the minority holder can instantly sell shares within a fraction of a point of the last reported sales, and can receive cash within 3 business days. This is not the case with a minority shareholding in a private company.

We look to the United States for empirical evidence of DLOM, and the most common sources include, but are not limited to, the Restricted Stock and Pre-IPO studies. There is also case


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law in the US that can provide some useful guidance as to the DLOM percentages the courts accepted in particular cases, and the factors they considered relating to the minority interests (we have seen discounts range from 10% to 95%).

A major consideration when estimating the DLOM is the expected time to liquidity event in the minority shares, since the greater the time expected to sell a minority interest, then the higher the discount and vice versa, as evidenced in the empirical data.

In quantifying the DLOM, you should at least consider the following factors, briefly summarised from US case law, in relation to your subject company and a minority holding therein.

### Factors decreasing the size of the discount

- Minority has put rights or favourable terms in a buy-sell agreement
- Dividend Payments
- Attractive company - profitability, growth prospects
- Attractive industry - profitability, growth prospects
- Good prospects for sale of the minority interest
- Large pool of available buyers
- Minority has good access to reliable information *(I.e.. Company is audited therefore good information)*

### Factors increasing the size of the discount

- Restrictive transfer provisions in place
- No dividend prospects
- Unattractive company
- Unattractive industry
- No prospect for sale
- Few identifiable buyers
- Poor access to information or unreliable information.

## Empirical support for a Discount for Lack of Control ("DLOC")

There are no empirical studies available relating to DLOC for minority interests.
It is important to note that the DLOC is the inverse of the Control Premium, as shown below:

$$\textbf{Minority Discount} = 1 - \left( \frac{1}{1 + \textit{Control Premium}} \right)$$

As such, in order to quantify the DLOC, you should typically seek transaction evidence for Control Premiums paid in the industry of the subject company.  From these Control Premiums, you can then imply the DLOC.


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