Indé Global
Business Appraisers

Valuation updates | Control premium

This thought leadership paper provides insights on the various issues relating to the usage of control premium in valuation.

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Perspective on control premium

The amount that a buyer pays to acquire control of a company typically exceeds the current market value of the company based on its market capitalization. The amount in excess that the buyer offers is commonly referred to as the control premium, as it gives the buyer a controlling interest in the company.

The issue of shareholder control is illustrated by the following example:

Suppose Mr B acquires 10 shares of Z Ltd, a publicly listed company, at the market price of $10 each. Here, Mr B is one of the many minority shareholders of Z Ltd and by virtue of his ownership of 10 shares he would have little influence in the decision-making of the Company. The $10 per share market price of Z Ltd in this scenario is reflective of the inability of Mr B (a minority shareholder) to influence those decisions.

However, if Mr B acquires 60% share in Z Ltd, which will enable him to influence the decision-making of the company, he may be willing to pay $15 instead of $10 paid in the erstwhile case. The additional $5 paid over the market price reflects the premium paid to obtain a controlling stake in the company. The rights and benefits granted to a control shareholder makes their share more valuable than minority shares.

<u>Control premium is defined as,</u>

"An amount or percentage by which the pro-rata value of controlling interest exceeds the pro-rata value of non-controlling interest in a business enterprise, to reflect the power of control. In practice, control premium is generally expressed as a percentage of minority value."

<u>Control and prerogatives of control,</u>

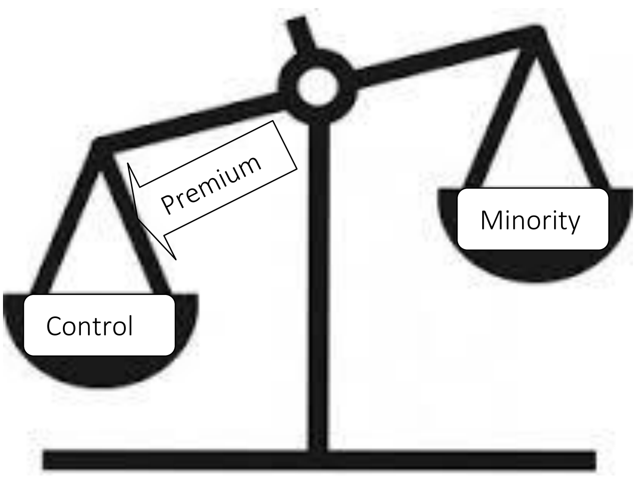
Control is the power to direct the management, dominate the decision making process, and set the policies of a business enterprise.

Control and the impact of control (or lack thereof) are important considerations in any valuation. An appraiser must ascertain the extent to which the subject interests being valued contain elements of ownership control.

Of all the intrinsic characteristics related to the subject interest, arguably, the element of control may be the most important characteristics. Widely accepted theory within the business valuation community holds that an investment in a privately held company is worth the present value of all of the future benefits inuring to the holder of that investment. Clearly, then, if the investor has a control position, he or she can accelerate the receipt of those future benefits and through management and operational initiatives, take direct steps to enhance the future benefits, or at least the probability that such benefits will be generated. To conclude, a controlling ownership interest will sell at a higher price than an equivalent non-controlling ownership interest.

The expected value of control is a product of two variables:

- The change in value from changing the way a firm is operated; and
- The probability that the change will occur.

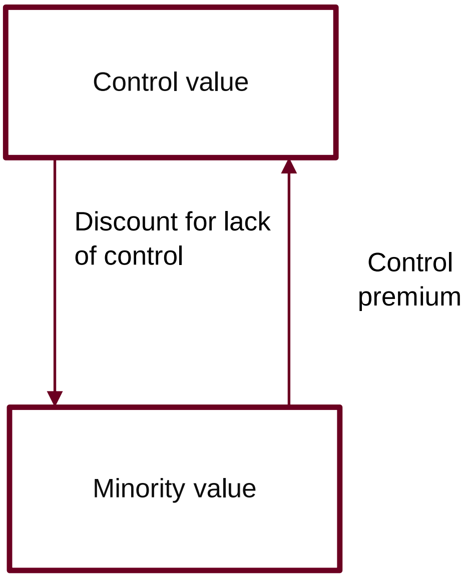


Applying control premiums

When dealing with discounts and premiums it is essential to specify the level of value to which they are applied. Levels of value are conceptual points at which the value of subject interest can be calculated.

There are three basic levels of marketability and control:

- the controlling interest (a controlling share in a public company or private company);
- the marketable minority interest (a minority share in a public company); and
- the non-marketable minority interest (a minority share in a private company).



Control premiums are only applicable in valuations where one is starting with lack of control value and is trying to arrive at control value. Therefore, when approaches and methods applied during a valuation exercise result in a control value, a control premium may not be applied. On the contrary, when a non-controlling value is the result of the business valuation approaches and methods applied, a control premium may be applied.

The following table summarises the application of control premium at various levels of value obtained using different valuation approaches:

Approach/ Method	Assumption	Resulting level of value	Whether to apply control premium
Discounted cash flow method - DCF	Control cash flows	Control	✗
	Minority cash flows	Minority	✓
Guideline public company method - GPCM	Multiple applied to control cash flows	Control	✗
	Multiple applied to minority cash flows	Minority	✓
Guideline transaction method - GTM	Transactions represent sales of controlling interests	Control	✗
	Transactions represent sales of minority interests	Minority	✓

Quantification of control premiums

One of the most common practices of arriving at control premiums involves relying on the data from actual transactions based on differences between prices at which publicly traded companies are acquired and the pre-acquisition announcement prices of the same stock.

Date	Price per share	Days before transaction
Day 1 – Monday	$ 21.50	6
Day 2 – Tuesday	$ 21.25	5
Day 3 – Wednesday	$ 23.25	4
Day 4 – Thursday	$ 23.75	3
Day 5 – Friday	$ 24.00	2
Day 9 – Tuesday	$ 28.00	Date of announcement
Control premium = (28.00 – 21.25)/ 21.25 = 31.8%		

The above methodology does not provide for quantification of buyer differences - specific transactions result from specific buyers with alternating motives. As such, transactions amongst synergistic buyers and transactions amongst financial buyers are not segregated**.**

Regulatory acceptance

<u>Control premium in United States</u>

Control premiums have enjoyed wide acceptance in the United States federal tax system.
The IRS[1] ruling on valuation of closely held shares, Revenue Ruling 59-60, clarifies this aspect. The ruling states:

"Although it is true that a minority interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock, it is equally true that control of a corporation, either actual or in effect, representing as it does an added element of value, may justify a higher value for a specific block of stock."

Court decisions and rulings employing control premiums have become the standard over the years, applying these principles not only to stocks, but other types of property as well. The business valuation community in 'non-estate/gift tax' venues also broadly accepts the application of these discounts.

[1] *Primary tax authority in U.S*

Insights on control premium *(cont…)*

Control premium in India

Although the Indian scenario lacks the legal guidance in respect of control premium, there have been significant instances of control premium being considered. Historically, control premiums were observed in more than 90 per cent of the transactions analysed thereby, reinforcing the relevance of control premiums in the Indian context.

For example, almost a year ago, Sun Pharma acquired Ranbaxy for an implied value of INR 457 for each Ranbaxy share, which was acquired at a premium of 18% to Ranbaxy's 30-day volume-weighted average share price and a premium of 24.3% to Ranbaxy's 60-day volume-weighted average share price.

The quantification of control premium in India is a tedious task due to lack of transactional databases for public as well as private companies. Research has shown that the control premium in India has ranged from 20% to 37% in the past few years. As per CCI guidelines, 15% discount for lack of control has been prescribed which is further subject to the appraiser's judgements.

One of the most common questions that appraisers face from their clients is how does the valuation methodology affect control premium?

The applicability of control premium does depend on the methodology used to arrive at the base value. Both income and market approach can produce value that may be either minority or control, and the appraiser must decide which level of value model best fits the specific case at hand and whether the cash flow that is being discounted ('DCF') or is being multiplied with a multiple ('GPCM/ GTM') is a control cash flow or a minority cash flow in order to determine whether control premium is to be applied or not.

- *IRS - Internal Revenue Service*
- *CCI - Controller of Capital Issues*

About us:

Indé Global Inc. specializes in international business valuation and tax advisory and is a member firm of KNAV International Ltd ('KNAV').

Our team comprises of over 350 professional executives with office in India, USA, Canada, Netherlands, Switzerland, France, UK and Singapore. Our valuation services encompass business valuation, intellectual property valuation and valuations for financial reporting purposes.

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