



Rajesh C Khairajani
Partner, Valuation

Valuation updates | Discount for lack of marketability

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

The concept of marketability

The concept of marketability centers on the ease with which the stockholder can convert his ownership interest to cash in terms of timing, the reliability of the quoted proceeds, and transaction costs. From a valuation perspective, the concept of marketability relates to a shareholder's ability to transform its interest easily into cash.

According to international glossary of business valuation terms, the marketability is defined as 'the ability to quickly convert property to cash at minimal cost'.

Perspective on the discount for the lack of marketability ('DLOM')

The discount for lack of marketability is an adjustment enabling professional business valuers to relate the marketable level of value with the non-marketable level. The international glossary of business valuation terms defines DLOM 'as an amount or percentage deducted from the value of an ownership interest to reflect the relative absence of marketability'.

Thus, DLOM is a downward adjustment to the value of an ownership interest to reflect its reduced level of marketability. Studies have shown that because investors are risk averse, they apply a certain discount to stocks that are not freely traded, as the inability to readily sell an ownership interest significantly reduces its value. To sum up, this discount is meant to act as a means of equalizing an ownership interest in closely held stock with an interest in publicly traded stock.

The rationale for DLOM

The marketability of an ownership interest in a private company is affected by two factors: the transaction time and the transaction costs. The transaction time refers to the period of time spent to sell the subject ownership interest. This situation is due to the fact that there is not a ready market for those interests to facilitate prompt sale. The unknown time for a sale is considered the fundamental rationale for discounts for lack of marketability.

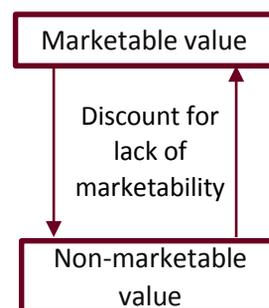
Secondly, the transaction involves incurrance of significant costs associated to selling. These costs are of two types: direct costs of the sale and, the opportunity costs. The direct costs of the sale are represented by legal, accounting and transaction fees.

The opportunity costs are represented by the cash-flows on alternative investments that are given up by the seller as a result of his incapacity to sell in short time.

Applying DLOM

DLOM is applicable under the following circumstances:

- DLOM is appropriate when the subject interest is non-marketable, and the valuation approaches and methods result in a marketable value; and
- DLOM is not appropriate when the approaches and methods have already taken marketability concerns into consideration.



DLOM should be determined considering the factors affecting the marketability of the subject ownership interest and should not be combined with other discounts such as discount for lack of control, blockage discount and so on.



Insights on DLOM

Quantification of DLOM

Valuation practitioners utilize numerous studies, methods and models as the source for quantifying DLOM. These studies, methods and models can be complex, indicating widely diverse conclusions, and may be appropriate in only certain limited situations.

DLOM is most commonly developed by reference to or analysis of restricted stock of public companies, or analysis of pre-IPO transactions in private companies that later went public, or other public stocks.

Each of these methods are discussed below:

- Restricted stock of public companies

The transfer of restricted stock is subject to restrictions laid out by the issuing company. These stocks have a limited private market, and their selling price can be readily compared to the price of the unrestricted stock sold in the open market.

The difference between prices at which restricted stocks, that are identical in all rights and powers except for their ability to be freely marketed, are issued relative to freely traded stocks of the same company, is considered a proxy for DLOM.

DLOM = price of unrestricted stock - price of restricted stock

- Pre-IPO stock price comparisons

This study analyses the stock prices of companies before and after they become public. The difference between these prices is attributed to the stock's marketability.

DLOM = price of stock post IPO - price of stock pre IPO

For DLOM, empirical evidence suggests discounts in the range of 20% to 50% may be appropriate. In practice, as the quantum is highly dependent on the valuation circumstances, the discount applied can fall within a much broader range.

While these empirical studies provide some support, the selection of an appropriate marketability discount remains one which requires significant professional judgement, analysis of the circumstances and the outcome of a full marketability assessment.

Regulatory acceptance

DLOM in United States

DLOM have enjoyed wide acceptance in the United States federal tax system.

The IRS addressed the issue of discounts for lack of marketability in revenue ruling 77-287, stating: *"Securities traded on a public market generally are worth more to investors than those that are not traded on a public market."*

The IRS valuation training for appeals officers, 1998 page 4-9, lists two primary court cases as the basis for discounts for lack of marketability.

In *Central Trust Co. vs. United States*, 305 F 2d 292 (Ct. Cl., 1962) the court of claims stated:

"It seems clear, however, that an unlisted closely held stock of a corporation, in which trading is infrequent and which therefore lacks marketability, is less attractive than a similar stock which is listed on an exchange and has ready access to the investing public."

In *Estate of Andrews*, 79 T.C. 938, page 953, the court stated:

"Even controlling shares in a non-public corporation suffer from lack of marketability because of the absence of a ready private placement market and the fact that flotation costs would have to be incurred if the corporation were to publicly offer its stock."

DLOM in India

DLOM in India is not backed by any statutory or regulatory base. However, as per erstwhile CCI guideline, 15% discount have been prescribed. It is recommended that the valuer should apply his own discretion in this matter.

Glossary

- **IPO - Initial public offer**
- **IRS - internal revenue service**
- **CCI - controller of capital issues**

Insights on DLOM (cont...)

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For expert assistance, please contact:
Rajesh C. Khairajani at: rck@igapl.com

Visit us at: www.igapl.com

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