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Discount for Lack of Marketability for a Closely Held Debtor Company

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A valuation analyst might be asked to value a closely held debtor company for various bankruptcy purposes. Depending on the business valuation approaches and methods applied, and the benchmark valuation data used, the analyst may conclude the value of the closely held company on a marketable basis. That is, the analyst values the company as if it was freely traded on a stock exchange. However, the subject debtor company is not public (not traded on a stock exchange), so the analyst may have to apply a discount for lack of marketability (DLOM) to reflect the illiquidity of a controlling (including 100 percent) interest in the debtor company (compared to an otherwise comparable public company). This article summarizes the following points: (1) empirical and theoretical models that analysts may use to estimate the DLOM, (2) application of the DLOM to the debtor company valuation, and (3) factors to consider in the DLOM selection.

Reasons to Apply an Adjustment

In the U.S. public capital markets, a security-holder can quickly sell most publicly traded securities at the last public trade price. The transactions typically occur at a very small commission cost; by contrast, the population of buyers for most closely held companies is a small percentage of the population of buyers for publicly traded securities.

In fact, it might be illegal for an individual or an issuer to sell closely held securities to the general public without first registering the security offering with either the Securities Exchange Commission (SEC) or a state corporation commission. Such a security-offering registration is an expensive and time-consuming process, and because of these differences in the ability to sell a closely held company (compared to publicly traded shares), empirical evidence suggests that the DLOM valuation adjustment might be significant.

In the valuation of a closely held debtor company, an analyst typically applies one or more of the three generally accepted business valuation approaches: market approach, income approach or asset-based approach. There is often a DLOM value decrement applicable to the analyst's initial company value indication due to the following two factors: the absence of a ready private placement market, or flotation costs (to achieve liquidity through a public offering). A business owner faces the following transaction risk factors when attempting to sell the closely held debtor company:

1. an uncertain time horizon to complete the offering or sale;
2. "make ready" accounting, legal and other costs to prepare for and execute the offering or sale;
3. risk as to the eventual sale price;
4. uncertainty as to the form (*e.g.*, stock or cash) of transaction sale proceeds;
5. an inability to hypothecate the subject equity interest; and/or
6. investment banker or other brokerage fees.

Next, we will analyze risk factors one through five. A summary of the sixth risk factor is presented in the cost to obtain liquidity studies (see discussion below).

Transaction Risk Factors

It may take months (or even years) to complete the offering or sale of a closely held debtor company. This uncertain (but considerable) time horizon contrasts with the principle of marketability. In addition, a business owner may incur substantial costs to prepare the debtor company for sale and execute the debtor company offering or sale.

A study published by Hsuan-Chi Chen and Jay Ritter concluded that underwriter costs alone typically represent 7 percent of the deal size in an initial public offering (IPO).[1] These underwriter costs do not include (1) related auditing and accounting fees; (2) legal costs to draft documents and clear contingent liabilities, and negotiated warranties; and (3) business owner administrative costs.

In "The Cost of Going Public," Ritter estimated these "other" transaction costs to be between 2.1 and 9.6 percent of the IPO proceeds.[2] The closely held debtor company may not achieve the expected business sale price because of several factors, including the following:

1. an overstatement of the business value on which the expected price is based;
2. an occurrence of debtor company events during the market exposure period that cause the sale price to decrease;
3. an occurrence of market events during the market exposure period that cause the sale price to decrease;
4. a lack of receptivity by capital markets to companies in the debtor company's industry; and/or
5. a lack of receptivity by capital markets to the debtor company.

If the debtor company sale proceeds are in a form other than cash, then the cash-equivalent transaction price might be less than the reported transaction consideration. Examples of debtor company sale proceeds components that may have a cash equivalency value below face value include (1) restricted public stock, (2) seller-provided below-market financing, (3) future contingency payments and (4) future earn-out payments.

Banks are reluctant to lend to business owners based on the value of a closely held company as collateral. Accordingly, it is difficult for the debtor company owners to borrow against the expected transaction sale price.

One consideration in the analyst's DLOM estimation for the closely held debtor company is the cost to obtain liquidity studies. These DLOM studies only apply to the analysis of a controlling (including 100 percent) ownership interest in the debtor company because all of the transactions considered in the studies relate to sales of controlling ownership interests.

The Cost to Obtain Liquidity Studies

The evidence that a valuation analyst considers to support the closely held debtor company DLOM is summarized below.

Transaction Costs

The various transaction costs related to the closely held debtor company sale typically include the following:

1. *Auditing and accounting fees:* These fees are incurred in preparing financial statements and related information for potential buyers and/or underwriters.
2. *Legal costs:* These costs are incurred in preparing documents, investigating contingent liabilities and negotiating warranties.
3. *Administrative costs (i.e., opportunity costs):* These costs are related to the time committed by company owners and managers to deal with accountants, lawyers, potential buyers and/or their representatives.
4. *Transaction and brokerage costs:* These business broker, investment banker or other transaction intermediary costs are sometimes referred to as "flotation costs." When these transaction costs are expressed as a percentage of the sale price, the percentage cost is referred to as the "gross spread."

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In a study published in 1987, Ritter analyzed the flotation costs typically incurred by the security issuer in an IPO.[3] The study indicates that larger companies generally negotiate lower underwriting fees as a percentage of the IPO gross proceeds.

More current flotation cost information is presented in a study conducted by Ritter and Chen published in 2000.[4] They examined the price spread (*i.e.*, the underwriter price discount) from 3,203 firm commitment IPOs from January 1985 to December 1998. The selected IPO transactions all had domestic gross proceeds of at least $20 million before the exercise of the overallotment option.

Ritter and Chen concluded that a significant number of IPOs were completed with a gross price spread of exactly 7 percent. In the 1985-87 period, 23 percent of all IPOs had a 7 percent gross price spread. Of the IPOs analyzed in the 1988-94 period, the amount of transactions with a 7 percent price spread increased to 60 percent. For 1995-98, 77 percent of all IPOs had a gross price spread of exactly 7 percent. Ritter and Chen observed that the price spread is larger for smaller companies, which indicates that a reasonable underwriter price discount for an IPO is 7 percent for companies with IPO gross proceeds exceeding $20 million.

PricewaterhouseCoopers LLP (PwC) published a study on IPO costs in September 2012.[5] PwC authors Martyn Curragh, Henri Leveque and Neil Dahr examined both the costs that a company incurs to make an IPO and the ongoing costs that a company incurs to remain a publicly traded entity.

The PwC study analyzed more than 380 IPO transactions between Jan. 1, 2009, and June 30, 2012. The PwC study examined the following costs associated with the IPO transactions: (1) underwriter fees, and (2) legal, accounting and other fees that are directly attributable to the IPO.

The PwC study concluded that the average cost paid to the IPO underwriter ranged from 5.5 percent to 6.9 percent of gross proceeds. In addition, the PwC study suggested a trend of decreasing costs as a percentage of gross IPO proceeds as the size of the IPO increases.

[1] Hsuan-Chi Chen and Jay Ritter, "The Seven Percent Solution," *Journal of Finance* (June 2000), at 1129.

[2] Jay Ritter, "The Costs of Going Public," *Journal of Financial Economics* (January 1987), at 269-81.

[3] *Id.* at 272.

[4] Chen and Ritter, "The Seven Percent Solution," *supra* fn.1.

[5] Martyn Curragh, Henri Leveque and Neil Dhar, *et al.*, "Considering an IPO? The Costs of Going and Being Public May Surprise You," PricewaterhouseCoopers LLP (September 2012), *available at* pwc.com/us/en/transaction-services/publications/cost-of-ipo-september-2012.html.

The PwC study quantified additional costs related to an IPO and suggested that the total costs associated with an IPO, on a percentage of gross proceeds, is actually greater than the 5.5 percent to 6.9 percent demanded by the underwriter. The PwC study presented evidence that reasonable underwriter fees range from approximately 5-7 percent, depending on the IPO's size. The PwC study also concluded that the additional costs associated with an IPO make the total costs, as a percentage of gross proceeds, greater than 5-7 percent. As previously mentioned, the seller of a closely held debtor company may incur other costs in addition to the underwriter fees and the "other costs" described above.

Only investment banker or other brokerage fees are included in the 7 percent liquidity cost measured by Ritter and Chen, and in the 5-7 percent liquidity cost measured by the PwC study. In order to measure the appropriate DLOM, an analyst should consider all of the costs to sell the closely held debtor company.

Subject Company Risk

Another factor that may affect the DLOM is the subject debtor company risk. Numerous studies have concluded that the DLOM size is related to the stock price volatility (one measure for risk). Numerous studies also attribute company size (another measure for risk) with the DLOM s ize.

Analysts generally agree that a large closely held company is a "safer" investment than a similar small closely held company, all other factors being equal. This conclusion is illustrated by comparing the expected rates of return on large-capitalization companies to small-capitalization companies. Ibbotson Associates makes this comparison:

> One of the most remarkable discoveries of modern finance is that of a relationship between company size and return.... The relationship between company size and return cuts across the entire size spectrum.... Small-cap stocks are still considered riskier investments than large-cap stocks. Investors require an additional reward, in the form of additional return, to take on the added risk of an investment in small-cap stock.[6]

Large companies are perceived as safer investments than small companies because larger earnings typically enable the company to withstand downturns in the economy and the debtor's industry and to capitalize on growth opportunities. Factors in addition to size can also affect the debtor company's risk. The following are some of the factors that may affect the subject debtor company risk: historical financial ratios and earnings trends/volatility; management depth; product-line diversification; geographic diversification; market share; supplier and customer dependence; deferred expenditures; and a lack of access to capital markets. The analyst typically considers how each factor will affect an owner's ability to sell the subject closely held debtor company.

Conclusion

An analyst might be asked to value a closely held debtor company for various bankruptcy reasons. Depending on the valuation approach and valuation method being applied and the benchmark valuation variable data being used, the analyst may initially conclude the value of the debtor company as if it was being traded on a stock exchange. In such a scenario, the analyst may need to apply a DLOM adjustment to conclude the value of the closely held debtor company. This article summarized the factors that analysts typically consider to measure the DLOM in the valuation of a controlling (including 100 percent) interest in a closely held debtor company. abi

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[6] *Ibbotson SBBI 2015 Classic Yearbook* (Chicago: Morningstar 2015), at 99 and 113.