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EVANS AND ASSOCIATES

VALUATION ADVISORY SERVICES

The Business Value Manager

Why 10% of a Private Company is Worth Less Than 10%

*Advice
for business
owners,
investors and
service providers
on how to build
value and wealth
through
investment in
closely held
companies.*

If you own stock in a closely held company and want to sell it, you can't just call your stock broker and expect to get your cash in a few days. If you own 100% of the private company stock, and your price expectations are realistic, it probably will take you six to twelve months to cash out and you may incur significant legal, accounting and transaction fees. So the 100% owner's liquidity in a private company is impaired by transaction delays and costs.

- Liquidate, sell-out, or recapitalize the company
- Pay (or not pay) dividends to shareholders
- Acquire, lease, or liquidate business assets
- Negotiate mergers and acquisitions
- Control the operation and course of the business.

For shareholders who own a minority interest in a closely-held company, their stock tends to be *much* less marketable and its value is reduced accordingly. After all, who wants to buy a minority interest in a private company where there may be little or no assurance of any annual cash return on their investment and little or no market available for a resale of those shares? That's why substantial discounts occur for the lack of marketability for minority interests in closely-held companies.

Majority Controls Dividends. From a practical standpoint, the owner of a minority interest in the company is at a severe disadvantage compared to the control interest. The control shareholder/manager is under no obligation to pay any portion of

the profits to other shareholders. Where the control shareholder is also the manager or president of the company, he or she will sometimes set his or her own compensation so high that no profits are

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Benefits of Control. Control owners possess the ability to:

- Appoint or change management
- Control the board of directors
- Set management compensation and perks

left to pay other shareholders any return on

(Continued on page 2)



Factors That Affect the Degree of Control

- * Ability of minority owners to approve certain corporate actions
- * Ability of minority owners to influence selection of members of the board of directors
- * Stock ownership pattern that provides "swing vote" influence to minority shareholder
- * Level of legal protection to minority shareholders
- * Presence or absence of voting rights
- * Company's history of consideration of minority shareholder interest

Factors That Affect the Degree of Marketability

- * Presence of restrictions on the transferability of shares of stock
- * Presence of buy/sell agreement that hampers transferability of shares
- * Degree of attractiveness of the block of stock
- * History and intent of dividend payments that are relatively small or large
- * Presence of a reasonably organized market for sales of companies in that industry
- * Presence of consolidation or pressures to consolidate in that industry
- * Likely population of buyers of that size interest in that industry

(Continued from page 1)

their investment. Control shareholders/managers may also hire family members and pass on to them as compensation the profits that might otherwise go to minority shareholders. Far from the exception to the rule, this is a common occurrence in private companies.

No Access to the Value of Assets. Many minority shareholders believe that the value of their shares is protected by the value of the underlying assets of the business. This is

seldom the case. Ownership of stock in a company does not grant the shareholder ownership of the underlying assets. The creditors of the company will always be ahead of shareholders if the company is liquidated, and the controlling shareholder can control - and prevent - the liquidation of the assets.

For all of these reasons, it is a well-settled law that a non-control interest, in most cases, is worth less per share than a control interest. The amount of the discount for lack of control is dependent on numerous factors, and its size can vary substantially.

Lack of Marketability Versus Lack of Control. The marketability - the liquidity - of stock shares is a concept that is distinct from the level of control, but related to it. While all closely held shares lack the liquidity that shares traded on a public exchange enjoy, their liquidity is influenced by the level of control. For example, the 100% control shareholder in the private company possesses relatively high liquidity: he or she can choose to sell the company, with marketability primarily determined by the time required to find a suitable buyer and close the deal and the associated transaction cost. This level of illiquidity often creates a discount that ranges from 3% to 15%. Conversely, the minority shareholder cannot force a sale of the company, frequently faces severe restrictions on the transfer of shares, and must find a buyer willing to invest in the unattractive lack of control interest. The result is severe illiquidity, which usually carries a marketability discount of at least 33% to 50% from a freely traded value.

"Control shareholders in private companies receive far less pressure to recognize and respect the needs and concerns of minority shareholders than would occur in a public firm which must disclose detailed information to regulatory authorities."

Measuring the Discount.

These discounts are often the largest adjustment to value made by the appraiser and usually have a material effect on the final opinion of value. The business owner who requires an appraisal for estate or gift tax purposes or related to a litigation frequently desires a high or low discount to achieve

his or her business goals. The properly experienced and

(Continued on page 3)

(Continued from page 2)

qualified business appraiser is intimately familiar with the market data that can be used to support discounts taken. Less qualified practitioners may choose a *lower* discount in an attempt to avoid challenge from the opposing side, with the result being that the business is over valued - *at the owner's expense*. The less experienced sometimes choose a *higher* discount to impress a client, only to find that they cannot defend their opinion under the harsh scrutiny of a qualified challenge, and the *shareholder pays* dearly as result.

"Because the value of closely held company shares of stock is materially influenced by relative levels of control and marketability, corporate boards should monitor share value and design strategies to manage and build value in light of these factors."

The key to appropriate and defensible discounts is retention of experts who possess a concentrated focus on business valuation, with the commensurate knowledge and expertise that proper education, credentials, and experience bring. Your appraiser should be able to comfortably discuss the market data and various studies on which the discounts are based. After all, it is with this expertise that the discount he or she had applied must be defended.

Value Management Opportunities. Shareholders and executives who manage their private company as an investment to build value should consider the following strategies in response to these lack of control influences on value:

1. Transfer shares in minority blocks at discounted values to minimize estate and gift taxes.
2. Transfer non-control interests while maintaining control over corporate decisions.
3. Recognize that variations in control and marketability can influence individual shareholder preferences for alternative corporate strategies. That is, recognize that strategies that are best for some shareholders may not be as beneficial for others.
4. Inform employees eligible for stock-based incentive compensation of the effect on value of degrees of control and marketability.
5. Review shareholder agreements to ensure that they clearly recognize the effect on value of variations in control and marketability so they can achieve their intended results without ambiguity. Many agreements are imprecise, which

can cause confusion - and hard feelings or litigation to resolve the unintended uncertainty.

Conclusion. Because the value of closely held company shares of stock is materially influenced by relative levels of control and marketability, corporate boards should monitor share value and design strategies to manage and build value in light of these factors.

Opportunity to Build Wealth

You can turn the unattractiveness of a minority interest to your advantage to minimize estate and gift tax liabilities. Transfer stock in minority blocks that qualify for high lack of marketability discounts, which generate low stock values. Sophisticated use of family limited partnerships offers additional powerful estate planning advantages.

But, be careful! The discounts derived must be defensible. That's where competent, experienced, credentialed valuation advisors

FIRST STEPS

To manage your business as an investment and take control of your life:

- Retain qualified valuation advisors to lead the process.
- Identify and prioritize your personal and financial goals.
- Quantify
 - Your company's return
 - Your company's risk
 - Your company's worth
 - Your company's return on investment

RESULT:

Armed with the information, you can devise the best strategy to achieve your business, personal and financial goals.

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Our Mission

Evans and Associates is a leading provider of strategic valuation advisory services. We maximize wealth and profits for individuals and corporations.

When your circumstances require measurement or management of business value, our focused approach provides solutions.

Our team's expertise in competitive analysis, finance and accounting, merger and acquisition, risk analysis and value creation forms the basis for our opinions and advice.

Typical engagements for Evans and Associates include specialized valuation consultation for the purpose of gift or estate planning, merger and acquisition, shareholder value enhancement and litigation support.

Evans and Associates Credentials Include:

Accredited Senior Appraiser
Certified Business Appraiser
Certified Public Accountant Accredited in Business Valuation

Shop Carefully for Valuation Expertise

Just as patients seek specialists for serious medical conditions, specialized qualifications are required in business valuation. Some credentials presented by so-called experts actually demonstrate no knowledge of business valuation. Others require little or no testing, work product review or experience to achieve.

Evans and Associates invites close scrutiny of our credentials. We have demonstrated the highest level of achievement in our profession, and are active locally and nationally in writing, speaking and governance. This expertise clearly results from our strategic focus and full-time commitment to comprehensive business valuation knowledge and service. Evans and Associates' credentials can be reviewed in detail at www.businessval.com

Personal Attention Backed by a Network of National Resources

Evans and Associates is a specialized valuation advisory firm small enough to provide the personal attention you want, but deep enough to possess the broad range of service expertise you may need. Our membership in the American Business Appraisers (ABA) National Network— we were the founding affiliate member—provides resources and advice from other nationally known valuation experts. Our ABA affiliation enables us to effectively execute virtually any valuation or merger and acquisition assignment.



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