

Levels of Control

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The type and the amount of appropriate valuation discounts and/or premiums are often matters of significant contention in business valuation controversies. The issue of the lack of ownership control covers a broad spectrum of factors that influence a business/security value. Both (1) the degree of ownership dispersion or concentration and (2) the degree to which the controlling shareholder can potentially divert economic income or perquisites from the noncontrolling stockholder to the controlling stockholder are important considerations in the application of a discount for lack of control.

INTRODUCTION

An ownership interest in a business entity that represents 100 percent, unilateral control of the entity is commonly referred to as a controlling ownership interest. An owner of 100 percent, unilateral control of an entity has valuable prerogatives of control that are typically not available to an owner of an interest that represents less than 100 percent, unilateral control.

An ownership interest of less than 100 percent, unilateral control of the entity is usually worth less, on a per share or a per ownership unit basis, than an ownership interest that has unilateral control.¹

Typically, the fair market value of an ownership interest—on a per ownership unit basis—decreases as the equity ownership interest decreases. For instance, in most circumstances the per ownership unit value of a 100 percent interest is worth more than the per ownership unit value of a 10 percent interest.

It is often not appropriate to refer to this reduction in value as a “minority interest discount.” This is because even an ownership interest that represents a unified block of the majority of the shares may suffer from a lack of control if the ownership interest represents less than unilateral control.

The decrement in per ownership unit value represented by that ownership interest’s lack of control

is more appropriately referred to as the “discount for lack of control.”

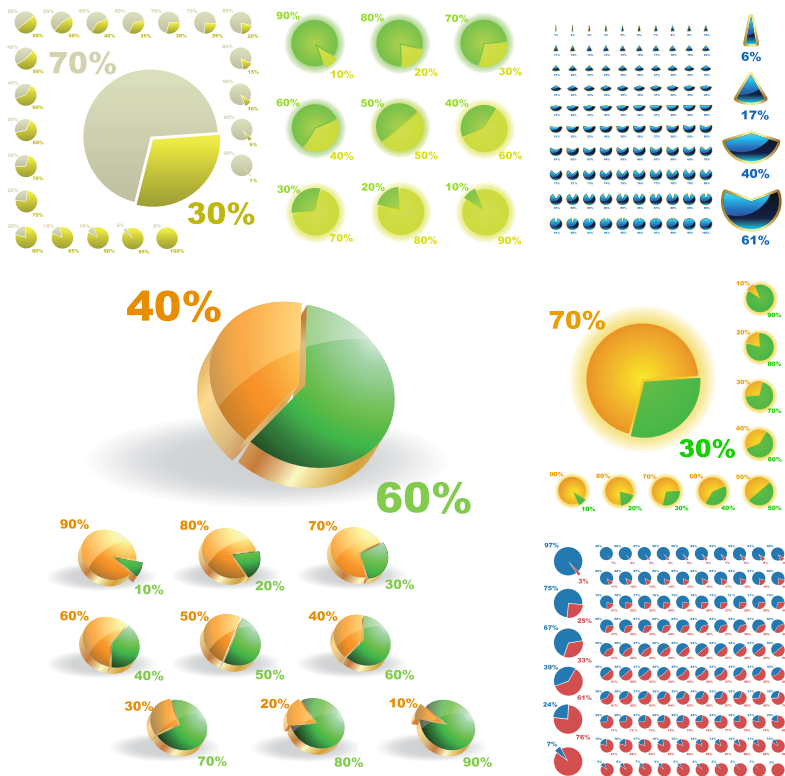
The size of the discount for lack of control is not necessarily the same for every ownership interest. Therefore, each ownership interest in the same company may not have the same value per unit.

DEGREE OF CONTROL

When the subject company is one where the ownership positions do not share and share alike, there are probably some dislocations in the per ownership unit value that are attributable to each ownership position’s lack of control.

Entity documents (e.g., articles of incorporations, partnership agreements, LLC operating agreements, and member documents) may delineate the bundle of rights that are controlled by certain entity owners. For example, many partnership agreements place specific decision-making power in the hands of the general partners, leaving the limited partners with little responsibility for operating the business.

Similarly, many LLC operating agreements place specific decision-making power in the hands of the manager or other designated LLC unit holders, leaving the owners of the limited (or nonvoting) LLC units with little responsibility for operating the business.



In many situations, the characteristics of the ownership interests of corporation shareholders are not clearly delineated in the corporate documents. Therefore, this discussion focuses on the following points of potential dislocation in the value of typical corporate level ownership:

1. Less than 100 percent, unilateral control but more than that required to exercise majority (or, if required, supermajority) control
2. Less than supermajority control but more than 50 percent
3. 50 percent ownership interest
4. Less than 50 percent but the largest ownership block in the corporation's stock
5. Less than 50 percent but in a "swing vote" position
6. Less than 50 percent and not in a "swing vote" position. This is essentially the position held by a "passive" investor

The size of the discount for lack of control is affected by a variety of factors, including the standard of value being applied. For example, some (but not all) judicial precedents have suggested that the

fair value standard that is to be applied in dissenting shareholder appraisal actions be interpreted to mean the pro rata business enterprise value without a discount for lack of control (or a discount for lack of marketability).

Before reaching a value conclusion, the analyst should take into consideration the standard of value and premise of value to be estimated, the purpose and objective of the valuation, the bundle of legal rights to be valued, and the ownership characteristics of the subject business interest.

PREROGATIVES OF CONTROL

In a corporation, the shareholders vote to elect the board of directors. The board of directors selects and hires the management team which will operate the company business. Among other duties to the shareholders, the board of directors provides advice to and oversight of the company management team.

An owner who controls all of the possible claims on the equity of the business² typically does not suffer from a discount for lack of control.

The perceived risk of an investment in a closely held, noncontrolling equity position is greater than in a control position. The difference in risk results in a difference in value between the controlling ownership interest and the noncontrolling ownership interest.

And, this difference in value is based on the actions that the owner of the control position could potentially take to the detriment of the owner of the noncontrolling position.

The perceived risk exists regardless of whether:

1. there is any evidence that the owner of the control position has actually exercised the prerogatives of control in the past or plans to do in the future or
2. the actions of the controlling owner would even be economically beneficial to the owner of the control position.

The following list provides a few examples of some of the common prerogatives of ownership control:

1. Elect directors and appoint management

2. Determine management compensation and prerequisites
3. Set policy and change the course of business
4. Acquire or liquidate assets
5. Select people with whom to do business and award contracts
6. Make acquisitions
7. Liquidate, dissolve, sell out, or recapitalize the company
8. Sell or acquire treasury shares, register the company's stock for a public offering
9. Declare and pay dividends
10. Change the governance requirements of the business such as articles of incorporation and bylaws

The above list illustrates that the controlling interest owner enjoys some very valuable rights that a passive investor does not. However, many factors may limit an owner's right to exercise some of the prerogatives normally associated with control, thus limiting the value accruing to the control position.

A willing buyer of a noncontrolling ownership interest would expect a price discount from the per share controlling ownership interest value of a company's stock in order for the investment to be attractive to the noncontrolling investor. The size of the price discount should reflect the risk that the noncontrolling interest holder could suffer from the actions of the controlling interest owner.

A willing buyer contemplating the purchase of a particular ownership interest from a willing seller would consider advantages and disadvantages arising from the ownership interest's degree of control.

In many situations, the business equity owners have agreements in place that address certain situations that the owners may encounter. For instance, some corporations have provi-

sions in their articles or by-laws that take some of these prerogatives out of the hands of any one owner.

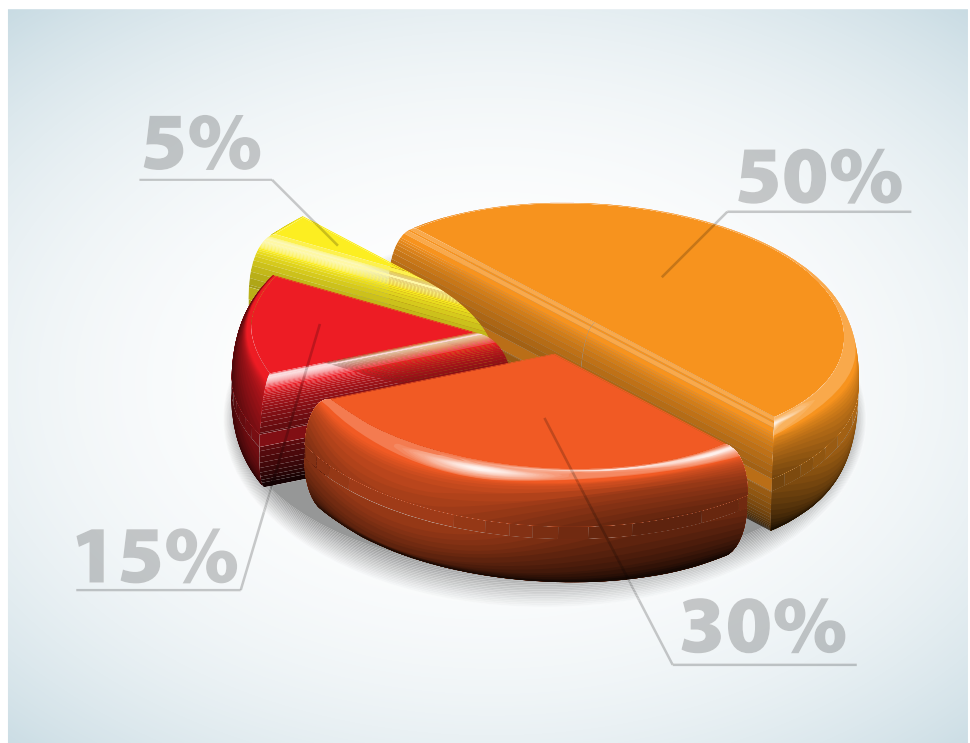
Shareholder agreements can also address some of these prerogatives by, for example, giving noncontrolling shareholders the right, but not the obligation, to participate on a pro rata basis in any change in control transaction initiated by the current controlling owner (often referred to as "tag along rights").

HOW THE BUSINESS VALUATION APPROACH AFFECTS THE LACK OF CONTROL ANALYSIS

Each generally accepted business valuation approach (i.e., income, market, and asset-based), depending on the specific valuation method applied, indicates a value with certain assumed ownership characteristics (e.g., control vs. noncontrol, marketable vs. nonmarketable).

The ownership characteristics of the value indicated by the selected valuation method affect, to a large degree, the price premiums and/or discount(s) that are appropriate for:

1. the subject standard of value and
2. the subject premise of value.



The selection and application of the business valuation approaches affect the application of the discount for lack of control.

THE INCOME APPROACH

The various income approach methods all have two basic elements in common:

1. A numerator consisting of an amount or amounts of expected economic income
2. A denominator consisting of a rate of return at which the economic income is either discounted or capitalized

The numerator—the expected economic income—generally has a significant influence on a controlling ownership interest value that was derived using the income approach.

Numerator

To the extent that the economic income projections reflect the ability of a controlling shareholder to realize more for the controlling interest than a noncontrolling shareholder could realize under the status quo, the income approach reflects the impact of control. And, the indicated value would represent an ownership level encompassing those elements of control.

If a controlling stockholder could enhance value to the controlling shares, but the impact of such

potential actions is not reflected in the economic income projections, then the indication of value may be on a noncontrolling ownership basis. And, a price premium for ownership control over the indicated value could be warranted if the valuation subject is a controlling ownership interest.

One common example of an economic adjustment that would dictate whether the analysis resulted in either a noncontrolling value or a controlling value is whether or not owners' compensation is adjusted to reflect the true economic value of the services rendered.

If a specific adjustment for owners' compensation was adopted, then this would move the income approach value indication toward a control ownership level of value rather than a noncontrolling ownership level of value.

The implication of this discussion is that (1) the justification for and (2) the amount of any valuation adjustment for ownership control (or lack thereof) to the value indications of the income approach largely depend on the ability of a control owner to increase the economic income paid to the control shares—over and above the amounts of economic income already accounted for in the income approach.

Denominator

In the case of a business acquisition, many analysts believe that the appropriate present value discount rate to use in the target company valuation (especially when fair market value is the standard of value), should be the target company's cost of capital, not the acquirer's cost of capital.

There are two conceptual components to the present value discount rate selection process:

1. The estimation of the appropriate cost of capital components (i.e., the cost of debt and the cost of equity)
2. The estimation of the appropriate ratio of the capital components in the subject company capital structure (i.e., the "mix" of the debt to equity components)



In many cases, the selection of a “control” present value discount rate versus a “noncontrol” present value discount rate would have a material effect on the value indication.

For example, let’s assume that the subject ownership interest is a noncontrolling ownership interest in a closely held business. The business is currently financed 100 percent with equity and the current market-derived cost of equity capital for such a business is 20 percent.

For the valuation of the noncontrolling ownership interest, the valuation analyst will probably use a present value discount rate of approximately 20 percent. For a controlling ownership interest in the same closely held business, based on market-derived evidence, the valuation analyst has concluded that the typical willing buyer would capitalize the company with 50 percent debt and 50 percent equity.

If the current market-derived (after-tax) cost of debt capital for such a business is 10 percent, then the analyst will probably use a present value discount rate of approximately 15 percent for the valuation of the controlling ownership interest.

Obviously, the difference between a 20 percent discount rate (applicable to a noncontrolling ownership interest) and a 15 percent discount rate (applicable to a controlling ownership interest) may have a material effect on the value estimates.

MARKET APPROACH—GUIDELINE PUBLICLY TRADED COMPANY METHOD

Because the guideline publicly traded company method derives a value based on trading activity of publicly traded noncontrolling shares, this method typically indicates a marketable, noncontrolling equity ownership level of value.

If conditions in the market for companies in the industry at the valuation date are such that control-



ling ownership interests can be sold for more than the aggregate value of the publicly traded minority shares, then the application of a control premium is probably appropriate if the subject interest is a controlling equity ownership interest.

MARKET APPROACH—GUIDELINE MERGED AND ACQUIRED COMPANY METHOD

Most merger and acquisition transactions involve controlling ownership interests. Therefore, if an indication of value is developed based on empirical merger and acquisition transactional data, an additional control price premium generally would not be appropriate. If the acquired interest is a noncontrolling ownership equity interest, a lack of control discount may be appropriate.

This is because the values indicated by this method generally are controlling ownership interest values. Therefore, a premium for ownership control may already be implicit in (1) the market-derived pricing evidence and (2) the indicated values.

The application of an additional control premium is not necessary in order to conclude a controlling ownership interest level of value. However, the application of a discount for lack of control may be necessary in order to conclude a noncontrolling ownership interest level of value.

“When using the asset-based approach, valuation analysts may have to use this two-step discounting process in order to indicate a nonmarketable, noncontrolling interest level of value.”

ASSET-BASED APPROACH— ASSET ACCUMULATION METHOD

The asset accumulation method generally indicates a controlling ownership interest level of value. This is because, typically, only a controlling stockholder could decide (1) to replace or liquidate the subject assets or (2) to

put the subject assets to their highest and best use in a going-concern context.

If the value of all of the subject company intangible assets is captured in the asset-based approach valuation, then noncontrolling shares typically would sell at a lack of control discount from the indicated value. In other words, if the application of the asset accumulation method encompasses (1) the value of all the financial assets, (2) the value of all of the tangible assets (at their highest and best use), and (3) the value of all the intangible assets, then a lack of control discount normally may be applied in order to indicate a noncontrolling equity ownership interest level of value.

We would like to think that if the income approach, the market approach, and the asset-based approach were all properly applied for a controlling ownership interest level of value, we would reach the same indicated value using all three approaches. If this were the case, then the amount of the lack of control discount to move from a control to a non-control level of value would be the same.

However, rarely do the data allow us to make such a simple adjustment. In the typical situation (and especially when using the guideline publicly traded company method), one set of market-derived data provides guidance for a lack of control discount to move from a marketable control level of value to a marketable noncontrol level of value. Then, another set of market-derived data provides guidance for a lack of marketability discount to move from a marketable, noncontrol level of value to a nonmarketable, noncontrol level of value.

When using the asset-based approach, valuation analysts may have to use this two-step discounting

process in order to indicate a nonmarketable, noncontrolling interest level of value. The data for the lack of control discount portion of this process are better for some industries than for others.

When using adjusted net asset value as a base, however, some empirical data unfortunately aggregate the lack of control and lack of marketability discounts so that they cannot be separately quantified. This is often especially true for limited partnership interests.

If a valuation analyst is starting from adjusted net asset value as an indicator of a controlling ownership interest, and the objective is to value a nonmarketable noncontrolling equity interest, then the analyst may either:

1. apply a discount for lack of control first and then apply a separate lack of marketability discount or
2. aggregate the two separate factors into a single combined discount.

Which of these two procedures is preferable in each valuation depends on the type of company and the quality of the empirical data available for quantification of the particular discounts.

ASSET-BASED APPROACH— CAPITALIZED EXCESS EARNINGS METHOD

The excess earnings method may be viewed as an application of the asset accumulation method by, for example, (1) adjusting tangible assets to fair market value and (2) aggregating all the intangible asset value into a single calculation—based on a capitalization of excess earnings.

The amount of earnings included in this analysis may be adjusted to reflect the prerogatives of ownership control. If the measure of earnings subject to capitalization corresponds to the earnings available to a control owner, then the capitalized excess earnings method typically indicates a control level of value.

If the measure of earnings does not, however, reflect the prerogatives of ownership control, and the tangible assets are not adjusted to market value, then the capitalized excess earnings method may indicate a noncontrolling equity ownership level of value.

Therefore, when considering whether a control premium or a discount for lack of control should be applied to a value derived from the capitalized excess earnings method, the valuation analyst should consider whether or not the prerogatives of ownership control have been reflected in the economic income used in the calculation.

ADJUSTMENTS TO THE BUSINESS ENTERPRISE VALUE

As you can see, important to the discussion of valuation discounts and premiums is the notion that they have no meaning until the base of value to which they are applied has been clearly defined.

A noncontrolling ownership interest discount reflects a lack of control and the base from which the discount is subtracted is often a shareholder's proportionate share of the total enterprise value (including all of the rights of ownership control).

A discount for lack of marketability typically reflects a lack of liquidity. Therefore, the base from which the discount should be subtracted is the value of an enterprise or ownership interest that is estimated on a marketable basis.

There are three basic valuation adjustments:

1. The discount procedure—based on a proportionate share of the overall business enterprise value, less a specific valuation adjustment to the enterprise value
2. The direct comparison procedure—based on a direct comparison of the subject ownership interest to other ownership interests that have the same valuation characteristics
3. The bottom-up procedure—based on the estimation of the economic benefits that the ownership interest holder expects to realize over the expected holding period of the subject investment

The discount procedure considers the “cost” of lack of control to the security holder in terms of a specific value decrement.

The direct comparison procedure relies on market-derived data regarding the sales of guideline or comparable noncontrolling securities (e.g., sales of other blocks of noncontrolling stock in the same closely held corporation).

The bottom-up procedure values the subject noncontrolling security by reference to the present value of all components of economic income that will be derived from the ownership of that noncontrolling security.

100 Percent, Unilateral Control

Obviously, an interest that represents unilateral control of the business does not suffer from a lack of control and, therefore, no lack of control discount should be applied.

Other valuation discounts may be applicable to a 100 percent ownership interest, depending on the base of enterprise value, but not a discount for lack of control.

For example, even controlling ownership interests may suffer to some extent from a lack of marketability (or dependence on a key person). It may take several months (or longer)—and a significant amount of expense and effort on the part of a single owner—to sell a 100 percent ownership interest in a company.

If the business enterprise value to which the discount is to be applied has been established based upon fully-liquid transaction values of comparable companies, then a valuation adjustment may be appropriate even for an ownership interest that represents absolute control.

Factors to Consider

The valuation analyst should first consider the scope of the valuation assignment. The purpose of the valuation assignment, the standard of value and premise of value, and the intended use of the analysis will have an impact on the factors to be considered by the valuation analyst.

Some of the factors that affect the bundle of rights affecting a particular ownership position of the subject business are listed below. These bundles of rights should be considered by a valuation analyst:

- Entity documents (e.g., articles of incorporation, membership or partnership agreement, by-laws)
- Governance practices (e.g., rights to seats on the board of directors, cumulative voting provisions)
- State statutes (including the right for a noncontrolling interest holder to seek dissolution of the business)



Less Than 100 Percent, Unilateral Control but More Than That Required to Exercise Majority (or, if Required, Supermajority) Control

An owner of a business entity who controls enough voting power to unilaterally change the entity's limitations regarding the prerogatives of control typically does not suffer from a discount for lack of control.

In some states, a simple majority (50 percent plus one share) vote can approve major actions such as a merger, sale of all of the assets, or liquidation of the company. Other states require a supermajority, two-thirds or even greater, vote in order to approve such corporate actions.

State property statutes may limit other prerogatives of control even for an owner of a supermajority ownership interest. In some states, such as California, under certain circumstances noncontrolling stockholders are able to bring a lawsuit to dissolve the corporation.

If the suit is successful and if the controlling stockholders wish to avoid dissolution, the remedy is to pay the noncontrolling stockholders the "fair value" for their stock.

To some degree, shareholders in a closely held corporation owe a duty of good faith and loyalty to one another. This duty typically requires the controlling shareholder to act with integrity and good faith in his or her dealings with the noncontrolling shareholders. This duty should prevent the controlling shareholder from engaging in oppressive or unfair negotiating tactics against the noncontrolling shareholder.

As a result, it may become a nuisance for the controlling shareholder to keep noncontrolling shareholders sufficiently informed when making certain corporate decisions. If the controlling shareholder wishes to force the minority owners to sell their shares, there are corporate reorganization techniques³ that can accomplish this goal.

Many state statutes give noncontrolling shareholders the right to vote as a class on certain amendments to a corporation's articles of incorporation that adversely affect the rights of those shareholders.

This noncontrolling class of shareholders may have the right to vote with respect to any merger in which (1) the subject company is merged into another corporation and (2) the subject company is not the surviving corporation.

- Contractual provisions (e.g., puts, calls, takeover provisions, tag-along rights, drag-along rights, buy-sell agreement that describes the application of premiums or discounts)
- Dilution protection (i.e., equity holders have the right to maintain their ownership percentage)
- Regulatory requirements (in some situations, corporate actions may not be taken without the approval of governmental authorities)
- Fiduciary duties (e.g., of the board of directors)
- Dispersion of the ownership of the remaining interests (as discussed briefly later)

Therefore, the noncontrolling shareholders may be able to oppose a merger in which the subject company is merged into another corporation and the company is not the surviving corporation, if the transaction proposed that the controlling shareholder would receive a per share premium over the noncontrolling shareholders.

If the controlling shareholder proposed a transaction in which all of the assets of the corporation were to be sold (and the controlling shareholder was to receive an unfair price premium per share), the noncontrolling class may have dissenters' rights in any sale of substantially all of the corporation's assets.

These examples demonstrate that the variations in state law concerning legal rights attributable to various equity ownership percentage interests have an important bearing on the valuation of a noncontrolling ownership interest.

As a result of these characteristics, the shares held in a block that represents unilateral control would usually be worth more on a per share basis than shares held in a block that represents supermajority control. And, shares held in a block that represents supermajority control would be worth more on a per share basis than the shares held outside that block.

Less Than Supermajority Control but More Than 50 Percent

In some states, even if there is a stockholder with a clear majority (i.e., over 50 percent) ownership position, the "majority" stockholder may enjoy relative control of the business—but not supermajority control or absolute control of the business. In order to exercise many of the prerogatives of control, the owner in this position may need the support of other owners in order to generate an economic advantage.

When incorporated in a state with a two-thirds supermajority ownership requirement, a stockholder with just over a one-third ownership interest in the company has the power to block many of the prerogatives of control.

In such a situation, the shares held in less than a supermajority block but more than 50 percent would be worth less on a per share basis than shares held in a supermajority block.

50 Percent Ownership Interest

When two people agree to invest equally and form a business in which each partner holds a 50 percent

ownership interest, they have agreed that their investment has some strings attached. Ownership interests of 50 percent represent neither a controlling ownership position nor a noncontrolling ownership position.

A 50 percent ownership interest can typically prevent certain actions from being undertaken by the company but cannot unilaterally cause an action to be taken.

Two 50 percent ownership interests may not have an equal level of control or lack of control. For example, one of the owners may have a contractual right to make certain decisions that would not require the other owner's approval.

If the contractual right (contained, for example, in governance documents or loan covenants) has been exercised to generate an economic advantage for one of the owners, then a difference in value between the two 50 percent interests may apply in certain situations. If that contractual right is transferable to a third-party buyer of that 50 percent interest, then the difference in value would probably apply in most situations.

Less Than 50 Percent but the Largest Ownership Block

This ownership position, while it may at first appear to have superior control attributes, usually cannot demand a price premium that is based on the potential for enjoying economic advantages associated with the prerogatives of control.

One large block of a publicly traded company (held by a founder's descendants, for example) is an example such a situation.

The owner of such a block may decide to seek a seat on the board of directors but, typically, a seat on the board of directors is not a legally transferable right connected to the ownership of the large block.

In fact, other valuation discounts may be applicable to such a significant percentage ownership interest, (depending, as always, on the base of value to which the discount is applied), in addition to a discount for lack of control. For example, this size of an ownership block may suffer from what some valuation analysts call a "blockage discount."

A blockage discount (related more to the ownership interest's lack of marketability than to its lack of control) is a deduction from the actively traded price of a stock because the block of stock to be valued is so large in relation to the actual sales on

the existing market that it could not be liquidated within a reasonable period of time without depressing the market.

Less Than 50 Percent but in a “Swing Vote” Position

An owner of a 2 percent interest might be in a position of limited control if there are two other owners each holding 49 percent. In a state where an ownership position of 50 percent plus 1 share can control most of the decisions regarding the operation of the business by voting for sympathetic board members (themselves, for instance), two of the three owners could combine their interests to assert control. In these situations, the characteristics of the individual owners, and their pattern of behavior, may affect individual share values.

More commonly, each of the three ownership interests may argue that value associated with a “swing vote” applies equally to their ownership interest, which means that it doesn’t apply to any one interest. A similar outcome could result in a situation where three owners each with a 33.33 ownership interest are sharing control of the business. In these three-owner situations, it may be appropriate to consider the negotiating position of—and the relationship between—each of the three owners.

Typically, when applying the fair market value standard of value (which is based on the amount that a hypothetical buyer would pay to a hypothetical seller in order to become one of the three owners) a price premium to recognize the swing vote position is not applied. This is because there is no transferable control characteristics embodied in any one of the three ownership interests.

In states that require a two-thirds—or even greater—supermajority vote in order to approve certain corporate actions, a stockholder with just over a one-third ownership interest in the company may have the power to block such actions.

In a situation where an equity holder owns an interest that is near the amount that is required for (majority or supermajority) control and the other ownership interests are dispersed among many holders, a price premium to recognize the swing vote position typically is not applied. This is because, typically, there is no transferable control characteristics embodied in any one of the ownership interests.

Less Than 50 Percent and Not in a “Swing Vote” Position—This Is Essentially the Position Held by a “Passive” Investor

This may be the most common situation in which the lack of control is analyzed.

When the analyst is applying the discount procedure (as distinguished from the direct comparison procedure or the bottom-up procedure described earlier) in this situation, a specific valuation adjustment is subtracted from the value available to the 100 percent absolute controlling owner.

To estimate the size of a discount for lack of control, analysts often begin by considering observed premiums paid to secure 100 percent absolute control of companies whose shares are publicly traded.

The market evidence available to quantify ownership control price premiums generally compares acquisition prices of publicly traded companies with preacquisition announcement prices of the same publicly traded stock.

The general idea of control premium studies is to measure the price premium over the noncontrolling ownership interest transaction prices at which a controlling ownership interest in the same company is transacted.

Such studies compare capital market prices for publicly traded stock before (1) the announcement of a merger or acquisition to (2) the final merger or acquisition price. The percentage of the acquisition price that was finally paid over the pretransaction stock trading price is commonly called the “control premium.”

As in many areas of business valuation, the empirical data available to quantify the ownership control premium are not perfect. The rea-



son is that all generally available control premium studies actually report—and quantify—transactional acquisition price premiums, not just ownership control premiums.

While it is likely that the reported data capture the value increment associated with ownership control, it is also likely that the reported data capture other value increments as well. Nonetheless, these empirical data sources are the best data available to quantify ownership control premiums.

To convert a price premium to a price discount from the acquisition price, the formula is:

$$\text{Price Discount} = 1 - \frac{1}{(1 + \text{Price Premium})}$$

For example, using an observed 25 percent premium, the discount would be 20 percent calculated as follows:

$$\text{Price Discount} = 1 - \frac{1}{(1 + 0.25)} \approx 0.20$$

SUMMARY AND CONCLUSION

Typically, there is a difference in value between the controlling ownership interest and a noncontrolling ownership interest. The issue of the lack of ownership control covers a broad spectrum of factors that influence value.

One category of factors is the degree of control elements that may not be present in any specific ownership interest. Another factor is the ability of a controlling shareholder to implement policies and practices that will enhance the value of the controlling shares—at the expense of the noncontrolling shares.

When dealing with price discounts and/or price premiums related to a controlling ownership position, it is important to know the base of value to which the discount or premium applies. The level of discounts and/or premiums should be appropriately matched to the level of value estimated.

When analyzing the lack of control associated with a particular ownership interest, there are three basic ways of applying valuation adjustments:

1. The discount procedure—based on a proportionate share of the overall business enterprise value, less a specific valuation adjustment to the enterprise value
2. The direct comparison procedure—based on a direct comparison of the subject own-

ership interest with the values of other ownership interests that have the same valuation characteristics

3. The bottom-up procedure—based on the estimation of the economic benefits that the ownership interest holder expects to realize over the expected holding period of the subject investment.

The value of individual units held in a block by a particular owner should reflect the concept of ownership control and the prerogatives of ownership control associated with that block (compared to the fewer economic benefits available to a noncontrolling stockholder).

There are numerous regulatory, legal, and contractual factors that affect:

1. the applicability of the ownership control price premium and
2. the quantification of the ownership control price premium.

Both (1) the degree of ownership dispersion or concentration and (2) the degree to which the controlling shareholder can potentially divert economic income or perquisites from the noncontrolling stockholder to the controlling stockholder are important factors in the application of a control price premium or a discount for lack of control.

Notes:

1. For there to be no difference in value between an ownership interest (on a per unit value basis) that has absolute control and an ownership interest that does not have absolute control, typically a comprehensive set of agreements are required that would protect the noncontrolling investor from the absolute control owner's potential for exercising its prerogatives of control to the disadvantage of the minority investor.
2. For purposes of this discussion, we assume that the board of directors has no duties to other company "stakeholders." For example, we assume that the company is not near a "zone of insolvency" which might limit a controlling equity holder's prerogatives of control.
3. A "squeeze-out merger" or a "reverse stock split" are two alternatives.

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