Implied Minority Discounts in Statutory Fair Value: The Doctrine That Just Won't Die

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Introduction

The points I will be discussing are:

- Levels of value
- The ambiguity of the phrase “control premiums”
- The statistical bias in acquisition premium studies
- Current views on IMD
- How to test whether or not IMD exists in a given situation

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Control Premiums and Levels of Value

The “levels of value” model is familiar to valuation experts from numerous articles and, particularly, from books by authors such as Shannon Pratt and Chris Mercer.

The levels of value chart in Pratt’s ***Valuing a Business*** shows five levels of value for publicly traded companies:

- Synergistic (strategic) value
- Value of control shares
- Market value of freely traded minority shares
- Value of restricted stock
- Value of non-marketable shares

The latter two levels are not relevant in a Delaware appraisal because marketability discounts are not permitted under Delaware law.

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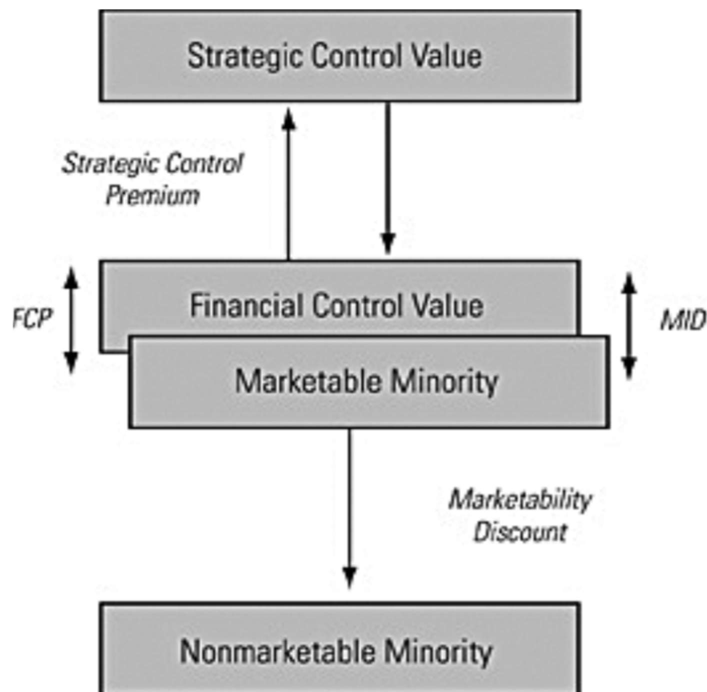
Mercer's Levels of Value

Mercer presents a revised levels of value diagram in his ***Integrated Theory of Business Valuation*** that shows Marketable Minority Value overlapping Financial Control Value.



SCP = Strategic Control Premium

FCV = Financial Control Value

FCP = Financial Control Premium

MID = Minority Interest Discount

MMV = Marketable Minority Value

Source: Z. Christopher Mercer and Travis W. Harms**, Business Valuation: An Integrated Theory**, 2nd Edition (Wiley, 2007), p. 71.

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Mercer Clarifies the Levels of Value

Mercer's is a coherent and useful levels-of-value concept.

- Strategic Control Value ("SCV")= Pratt's "synergistic value" = the company's value to a party that could achieve synergistic benefits if it had control.
- Financial Control Value ("FCV") = value without anticipated synergies, but including "the ability of a specific buyer to improve the existing operations or run the target company more efficiently."
- Marketable Minority Value ("MMV") = Pratt's market value of freely traded minority shares.

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Most Public Companies Trade at FCV

Mercer points out that public market prices may exceed Strategic Control Value at a level he calls "Apparently Irrational."

We have all seen numerous examples of this, such as the "dot.com" bubble in the late 1990s.

Mercer says :

> *[U]nless there are cash flow-driven differences between the enterprise's financial control value and its marketable minority value, there will be no (or very little) minority interest discount.*
>
> Since most public companies are not taken over,. . . *the marketable minority and financial control value of most public companies approximate each other."*

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What Level of Value Is Used in a Delaware Appraisal?

Under Delaware case law, a company must be appraised on an "as-is" basis – as a going concern based on the way it is being managed at the time of the valuation – a concept called "operative reality."

Hamermesh & Wachter call it "warts and diamonds."

Going-concern value based on operative reality does not include potential benefits such as cost savings that an acquirer may achieve, such as eliminating the costs of being a public company, reducing excessive management compensation, or running the business differently.

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Delaware Appraisal Value Should Be Marketable Minority Value

Delaware appraisal value (going-concern value) generally should equal MMV.

Where there are any potential cost savings available to an acquiror, the going-concern value of the company being appraised would be lower than FCV.

When market prices are depressed and shares trade below their going-concern value, then the going-concern value of a company under Delaware appraisal law would be higher than MMV.

When the Court calculates going-concern value based on "warts and diamonds," it arrives at MMV.

The company is valued as a going concern as it is being run by existing management.

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Adding IMD Changes the Level of Value

The guideline company method calculates MMV.

When the Court decides to adjust for IMD, the Court attempts to exclude synergies and then determines the IMD by reference to testimony as to premiums paid in acquisitions.

By adding IMD to MMV, the Court arrives at FCV, which includes cost savings that a financial acquirer may achieve.

Thus, the Court's going-concern DCF valuations arrive at a **different level of value** than its guideline company valuations adjusted for IMD.

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Multiple Meanings of “Control Premium”

Courts have used “**control premium**” with 3 different meanings.

Meaning #1: FCP = **difference between FCV and MMV** = the inverse of minority interest discount.

Meaning #2: SCP = **difference between SCV and FCV**.

The use of SCV is impermissible in a Delaware appraisal (except, inexplicably, in valuing subsidiaries of holding companies).

Meaning #3: **the difference between acquisition price** (SCV when SCV>FCV) **and MMV**, which is the sum of Meanings #1 and #2. This is the observable number measured in control premium studies.

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Clarifying Meanings of "Control Premium"

It would be helpful if the Court, authors, and expert witnesses shared a common language based on a commonly-shared conceptualization.

The "control premium" ambiguity could be avoided if experts used the levels-of-value model and the financial community's newer, more precise terminology.

Clear testimony could help the Court in at least two ways:

- Distinguishing between FCP and SCP by using the word "Strategic" or "Financial" as appropriate, rather than just "Control Premium."
- Using the phrase "**Acquisition Premium**" to describe Meaning #3: the difference between acquisition price and MMV.

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"Acquisition Premium"

The premium used in control premium studies is the Acquisition Premium, *i.e.,* the difference between acquisition price paid and MMV .

- As noted earlier, the acquisition premium is the only premium that is directly observable in the market.
- Acquisition price is usually SCV, but it equals FCV when SCP = 0.
- Since the SCP must be excluded in a Delaware appraisal, it becomes necessary for experts and the Court to estimate (or speculate) as to the unallowable portion of an Acquisition Premium attributable to synergies (the SCP).

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Average Premiums Are Not Meaningful

Average premiums paid in acquisitions are not useful to the Court.

Average premiums paid in acquisitions are statistically biased, because data used in calculating average acquisition premiums includes a substantial built-in upward bias.

These premiums are computed in relation to target companies' market prices prior to announcement of the relevant transaction.

The databases consist primarily of those companies which acquirers believe to be worth more than market price.

Thus the universe of guideline transactions includes companies which were undervalued in the market but necessarily excludes companies that acquirers consider overvalued.

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The Fallacy of Average Premiums

Thousands of companies are publicly traded, but only a small portion of them are acquired in any specific year.

Professor Bradford Cornell wrote in 1993:

> *The fact that most **companies do not receive takeover bids** at premiums above market price indicates investors believe that the shares of those companies are not worth significantly more than market price* [emphasis in original].

Professor Richard Booth wrote in 2001:

> *[I]t is not necessarily the case that actual market price is always less than fair market price. If it were, then there would be no such thing as a fair market price*.

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The Courts Have Relied on Flawed Data

The Chancery Court's belief that guideline companies suffer from an IMD, as well as the Court's quantifications of IMDs, have generally been based on expert testimony as to average acquisition premiums.

The Court, therefore, has relied on data that is seriously flawed and statistically unreliable.

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Investment Bankers Misuse Average Acquisition Premiums in Fairness Opinions

The Courts have been further misled by the fact that many investment bankers include average acquisition premiums as one of several measures in arriving at fairness opinions, even though the method is not statistically valid.

The use of average acquisition premiums as a measure of value has been mistakenly accepted by many in the financial community.

My review of all published fairness opinions in cash acquisitions during the 12 months from September 2007 through August 2008 (179 fairness opinions in 160 transactions) shows that just over half (90) of the fairness opinions used average premiums paid as a standard of fairness!

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Experienced Firms Seem Less Likely to Use Average Premiums in Fairness Opinions

This widespread use by investment bankers of the premiums paid method gives a façade of respectability to the reliance on average acquisition premiums.

However, the more fairness opinions a firm issued in the 12-month period reviewed, the less likely they were to use a premiums paid analysis. The premiums paid method was used by:

- 78% of 40 firms issuing one fairness opinion
- 68% of fairness opinions by firms issuing 2 to 4 opinions
- 25% of fairness opinions by firms issuing 5 or more opinions

In my view, this is evidence that the firms with the most experience in fairness opinions seem to be less likely to use the unsound premiums paid method.

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Valuation Experts' Views of IMD

The presumption of an IMD was first questioned by Eric Nath in a 1990 *Business Valuation Review* article.

Nath posited that the freely traded market prices of a company already had incorporated the company's financial control positives or negatives and thus reflected control value.

His theory stimulated a great deal of debate and was generally opposed in the 1990s. But the position of other commentators gradually shifted, and Nath's position is now widely accepted.

Pratt implicitly agreed with Nath in *Business Valuation Update* in 1999:

> *Valuation analysts who use the guideline public-company valuation method and then automatically tack on a percentage "control premium'" . . . had better reconsider their methodology.*

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Mark Lee's Valuable Insights

Mark Lee wrote in ***Business Valuation Update*** in 2001:

> *If there is no M&A market available to sell a company at a premium to its stock market value, then there is little or no acquisition premium, much less a "theoretical" premium based on an average of acquisitions of dissimilar companies.*

Lee pointed out, "Factors influencing the stock market often do not coincide with those affecting the M&A market."

He illustrated the fact with a diagram (on the next slide) showing that the stock market and the M&A market are separate markets, albeit with some overlap.

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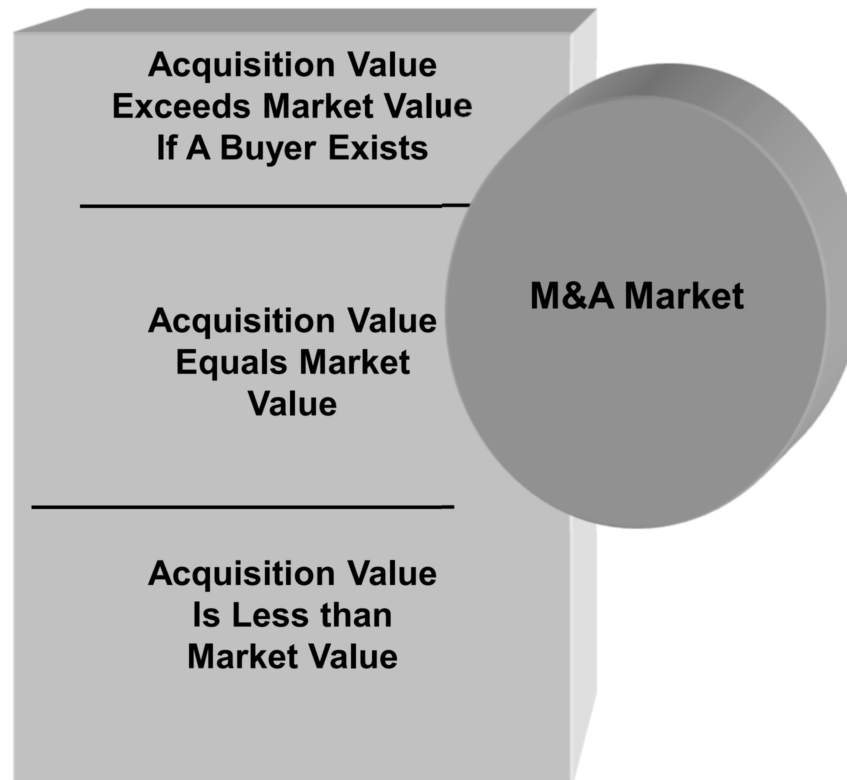
Mark Lee's Diagram



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The Diagram If All Market Prices Included IMD

If all market prices included IMD, then the M&A market in Lee's diagram would hover over the market like the dot on an "i" instead of overlapping it.

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Mark Lee's Valuable Insights continued

Lee further wrote in 2004 that "the acquisition value of a company may be equal to or below its market value," explaining:

> *While a company may be viewed as very attractive to a purchaser of a minority interest in the public market, the company as a whole may be perceived as too risky at its publicly traded market price.*

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IMD Is No Longer Accepted by Valuation Experts

In addition to Nath, Hamermesh & Wachter, Pratt, Lee, and me, others have expressed their views that publicly traded shares usually do not include IMD.

Mercer in his 2004 book discussed his past disagreement with Nath. He wrote that he has changed his view and now concurs with Nath.

Philip Clements and Philip Wisler wrote in their book ***Fairness Opinions*** in 2005:

> *The control value of a company may not differ greatly [from] and may even be below its publicly traded minority share value*.

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The Courts Have Relied Upon Authors Who No Longer Support IMD

In accepting IMD, the Delaware courts were following *Weinberger*'s injunction to make their valuations in accordance with accepted financial practice.

When Pratt wrote in 1996 that the guideline company method "usually requires some adjustment from the publicly traded minority stock value equivalent to account for control," that was the then-accepted view of the financial community.

In contrast, Pratt's 4th Edition of ***Valuing a Business*** (2000) included his 1999 *BVU* comment that warned analysts not to automatically add percentage control premium to guideline company valuations.

However, some of the IMD decisions since 2000 have cited experts' older books containing positions that the authors had modified in later books before those decisions were rendered.

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The Courts Have Relied Upon Authors Who No Longer Support IMD continued

In *Agranoff* (2001), for example, the Court cited Pratt's 1996 view. The Court in 2001 was apparently was not aware of Pratt's changed view.

Pratt further clarified his revised position in ***Business Valuation Discounts and Premiums*** (2001). After an extensive discussion of various articles and seminars regarding the issue of whether market prices reflect control value, Pratt quoted Lee's 2001 article and concluded,

In any case, it is obvious that, given the current state of the debate, one must be extremely cautious about applying a control premium to public market values to determine a control level of value.

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Valuation Experts No Longer Support IMD

Mercer's 1st edition of ***The Integrated Theory of Business Valuation*** in 2004 presented the modified levels-of-value diagram that showed MMV overlapping FCV.

Thus, although earlier Pratt and Mercer citations supported **pre-1999** decisions regarding IMD, since then neither has held that publicly traded shares customarily include implied minority discounts.

> Nonetheless, the Court, in its 2005 *Andaloro* decision, continued to cite Pratt's 1996 thinking in support of an IMD adjustment. Yet the Vice Chancellor cited Pratt's 4th Edition (2000) in the same decision when discussing discounted cash flow!

Most leading valuation experts now concur that market prices of actively traded shares usually do not include IMD.

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IMD Should Not Be Imputed Unless There Is Evidence to the Contrary

The default assumption should be that no IMD should be imputed unless there is specific data that indicates otherwise.

- Without evidence that the prices of guideline companies include minority discounts, there is no reason to adjust for IMD.
- However, because the market is sometimes inefficient, IMDs may arise.
- The analyst must make a decision in any guideline company analysis whether or not an IMD is applicable.
- When applicable, an IMD must be quantified based on an appropriate analysis.

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How to Test for IMD and, If Appropriate, Quantify It

In determining whether IMDs are present, the valuation expert must consider the relation between market multiples and transaction multiples.

1. If there are no recent guideline transactions, market prices of guideline companies are probably not at levels that are attractive to acquirers, making IMD moot.
2. Quantify an IMD (if any) by comparing the average multiples of guideline companies with average multiples of guideline transactions.
3. If available, examine data for relevant transactions in which large minority interests are acquired.

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How to Test for IMD and, If Appropriate, Quantify It continued

4. Estimate the adjustments to be made to multiples of guideline transactions to eliminate any synergistic benefits excludable in a Delaware appraisal.
5. An example of a transaction with evidence of synergies is a merger of competitors or related businesses.
6. An example of a transaction with little evidence of synergies is a purchase by a financial buyer who does not own a competitor or related business.
7. Adjustments are required for transactions that were priced at earlier dates under different market conditions.

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Addendum:
Overvaluation of Subsidiaries

The use of a Strategic Control Premium is impermissible in a Delaware appraisal **except, inexplicably, in valuing subsidiaries of holding companies.**

In three cases in the 1990's, the Court permitted acquisition premiums to be added in valuing subsidiaries of holding companies.

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Harris v. Rapid American Corp. (1992)

The Chancery Court valued each subsidiary based solely on guideline companies.

The Delaware Supreme Court concluded that the Chancery Court had effectively "treated *Rapid* as a minority shareholder in its wholly-owned subsidiaries" because market prices of guideline companies "do not reflect a control premium."

The Supreme Court reasoned was that the inherent value of the parent holding company included control value of its 100%-owned subsidiaries.

On remand, Chancery Court applied "control premiums" to the three subsidiaries that were the average premiums paid in acquisitions in the subsidiaries' respective industries, *i.e.,* acquisition premiums.

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LeBeau v. M.G. Bancorporation (1998)

M.G. Bancorp was a bank holding company with two bank subsidiaries.

The Court of Chancery, following *Rapid American*, added a control premium to the guideline company valuation.

I wrote in *BVU* in 1998:

> *This reasoning leads to the absurd conclusion that **a business conducted through a subsidiary is entitled to a control premium, but an identical business conducted through a division is not**! The application of a control premium at a subsidiary level, when such premium is not permitted at the parent level, is an anomaly that is difficult to justify.* [Emphasis added]

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Hintmann v. Fred Weber, Inc. (1998)

An acquisition premium applied in *Hintmann* to a single operating subsidiary.

I wrote in *BVU* in 1998:

> *If [Weber] Industries had not been a holding company, but had owned FWI as a division,* Rapid-American *would not have applied and there would have been no control premium added. This elevates form over substance.*

Hintmann is unique in applying IMD to a DCF valuation. Few, if any, experts would consider it proper to add a control premium to a DCF calculation.

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Adding a Control Premium to a Subsidiary's Value Seems to be Contrary to the Statute

In adding average acquisition premiums to the going-concern value of subsidiaries, the courts effectively award a Strategic Control Premium.

Using a Strategic Control Premium appears to be contrary to the appraisal statute's mandate that "the Court shall determine the fair value of the shares **exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation**."

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