The Advisor – Spring 2014

Liquidity and Control in Valuing a Business

Most business owners and shareholders think they have a good idea of what their shareholdings are worth. Yet when it comes time to sell, many are surprised by the cut-rate offers that are made.

Most will chalk it up to negotiating tactics, in that no one wants to pay more for a target than they have to. But it could be that the initial valuation shareholders have about their company is inflated in the first place.

Valuation theory states that when valuing a business, a valuator should start with a base case which assumes the shares of the business are liquid (i.e. actively traded on a public stock exchange) and that all shareholders have equal amounts of control over corporate governance. If this is not the case, then adjustments to the valuation need to be made from the base case.

It follows that if the shares of a company are privately held, they would be priced at a value lower than the base case due to their lack of liquidity.

How much of a discount depends on a number of factors including:

- The profitability (or lack thereof) of the company;
- Whether dividends have, or are likely to be paid on the shares;
- The existence of a ready market to buy the shares; and
- The estimated time required to sell the shares if one was forced to.

In short, the greater the uncertainty and estimated time to sell the shares, the higher the discount will be.

However, if a shareholder has control of a publicly traded company, his shares should trade at a premium to the base case. That is, he has the ability to elect a majority of the members of the Board of Directors of the company. It is the Board that establishes the strategy and direction of the company and hires the management team to execute the strategy. In most cases, this means owning 50.1% of the firms voting shares. But in cases where shares are freely held amongst numerous shareholders, control could be exerted with as little as 20% of the votes.

Publicly traded companies that have a duel class structure of shares are perfect examples of control premiums. The voting shares will always trade at a premium to the non-voting shares.

© Aries Advisory Group Ltd. 2014

Size is another consideration when valuing a business. If a business generates sales of $50 million and a comparison company generates twice that amount, one should expect a discount from the comparison company's value. A smaller sized company is usually a riskier investment as it would not be able to withstand negative impacts (ex. loss of a key customer or supplier) as easily as a larger one.

So if you are the majority owner of a privately held company, you should expect a discount when comparing your shares to a public company. This holds true even if you own 100% of the voting shares as the liquidity discount will usually be greater than any control premium. Be prepared for a further discount if your company is materially smaller than the public company.

Finally, if you are in the unenviable position of being a minority shareholder in a privately held company, you may unfortunately be subjected to a minimum of two discounts – one for lack of liquidity and one for lack of control. One way a minority shareholder can protect himself from a minority discount is to enter into a shareholders' agreement at the time of the investment which establishes the price of the shares under various sale scenarios. A prudent shareholder will include "tag along" rights in the agreement which forces a buyer to buy his shares at the same price as that offered to the majority shareholder.

Aries Advisory Group is uniquely qualified to assist you with the sale of your business. We can perform an independent valuation of your business and determine what the reasonable discounts or premiums to comparable companies should be. We can then negotiate on your behalf to ensure you obtain the best price for your business. Please contact us at info@ariesag.com or at (416) 467-7878 to see how we can help.

© Aries Advisory Group Ltd. 2014