

# BDG Business Valuation Insight

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## Look for the silver lining

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A valuation provision must be at its heart



BECHER  
DELLA TORRE  
GITTO & COMPANY

Certified Public Accountants  
A PROFESSIONAL CORPORATION

76 North Walnut Street  
Ridgewood, New Jersey 07450

(201) 652-4040  
[www.bdgcpa.com](http://www.bdgcpa.com)

# Look for the silver lining

A volatile market translates into higher marketability discounts

Marketability is the ability to quickly convert property to cash at minimal cost, according to the *International Glossary of Business Valuation Terms*. Also implied is a high degree of certainty that an expected selling price will be realized.

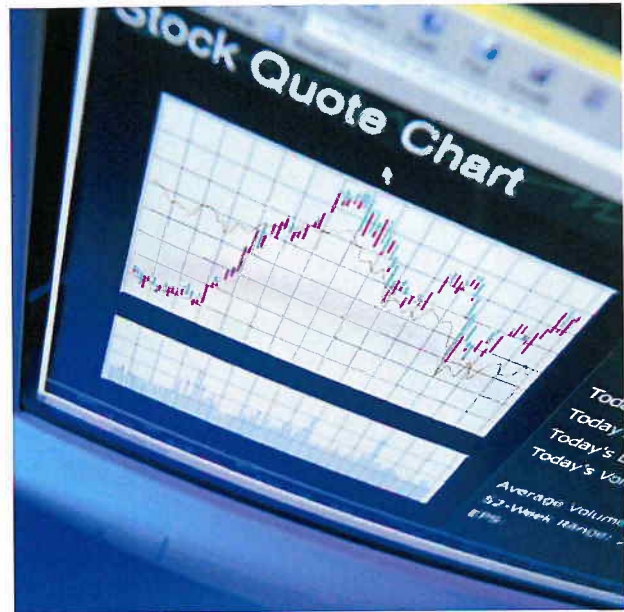
But if there's one thing the market has *not* been over the last couple of years, it's certain. Recent market volatility may well translate into higher marketability discounts, because investors pay less for illiquid, risky investments. So the silver lining to economic uncertainty is that it provides an opportunity for wealthy individuals to gift private business interests at significant discounts, potentially saving a substantial amount in taxes.

## Gauging investor sentiment

High volatility typically lowers marketability by making investments less attractive. But estimating private stock price volatility can be difficult because published stock prices for privately held shares don't exist — and private transactions are few and far between. Recently, valuers have turned to public volatility metrics to capture the specific effect volatility has on private marketability discounts.

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One popular gauge of market volatility is the Chicago Board Options Exchange Volatility Index® (VIX®). VIX measures the expected volatility of Standard & Poor's (S&P) 500 index options over the next 30 days. Also known as the "fear index," VIX tells whether investors expect sharp changes in market prices — either upward or downward.



In general, a VIX of 30 indicates relatively high volatility while a score of 20 or less suggests calmer market conditions. In October 2008, VIX approached 90, a record high since the index started in 1993.

In an annually published database, *The FMV Restricted Stock Study™*, FMV Opinions provides a comparison of restricted stock transactions in the first and second halves of 2008 showing a direct relationship between VIX and observed restricted stock discounts. This empirical evidence indicates that volatile market conditions warrant higher marketability discounts.

## Looking beyond volatility

The two most popular sources of empirical data valuers use to support marketability discounts are restricted stock and pre-initial public offering (IPO) studies, according to a September 2009 *BVWire™* poll. These studies suggest that marketability discounts for minority interests in private companies range from 30% to 50%. But marketability discounts

can vary significantly depending on the specific characteristics of the subject business interest.

Volatility is just one factor that affects marketability. Other considerations include:

**Put rights.** The owner of a put option has the right, but not the obligation, to sell his or her interest at a prescribed price — usually for a limited time. Put rights are frequently granted to employee stock ownership plan (ESOP) participants. Put rights create a market for transferring ownership and, therefore, support a *lower* marketability discount.

**Pool of potential buyers.** The more potential investors that are available — often demonstrated by historic trading volume — the more marketable the

business interest is and the *lower* the marketability discount. The size of the investor pool also may be statutorily restricted. For instance, in some states, only licensed professionals can own an interest in a law firm or medical practice. Similarly, tax regulations limit S corporation ownership.

**Company size and financial performance.** Investors often perceive small companies, startups and underachievers as riskier ventures. Accordingly, these underdogs warrant *higher* marketability discounts.

**Size of the block.** Large blocks of stock take longer to sell and may flood the market with excess supply. Large blocks also have fewer potential buyers and are harder to finance. So, the size of the block and the marketability discount are positively correlated.

## A quick-and-dirty marketability checklist

A September 2009 *BVWire*<sup>TM</sup> poll of valuation professionals found that 83% routinely refer to the case *Bernard Mandelbaum, et al. v. Commissioner* and consider the *Mandelbaum* factors when quantifying marketability discounts. These nine factors include:

1. Financial statement analysis,
2. The company's dividend policy,
3. The nature of the company, its history, its position in the industry and its economic outlook,
4. Company management,
5. The degree of control in transferred shares,
6. Restrictions on transferability,
7. The holding period,
8. The company redemption policy, and
9. The costs associated with making a public offering.



The poll suggests that the most relevant criterion is transfer restrictions, with 98.7% of participants considering whether buy-sell or other owner agreements restrict stock transfers. The factor with the lowest response rate (39.7%) was initial public offering (IPO) costs.

While they may not specifically cite the controversial *Mandelbaum* case in their valuation reports, most experienced valuers look beyond empirical study averages and make specific connections between transaction data and the business interest in question.

