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BUSINESS VALUATION ALERT

FMV's Two-Year Equivalent Discounts for Lack of Marketability[1]

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Greater liquidity resulting from shorter initial holding periods and registration rights has led to questions about the meaningful comparability of recent restricted stock transactions to private companies. FMV has now solved this problem by deriving a "Two-Year Equivalent Discount" that makes current data meaningful in the determination of the appropriate discount for lack of marketability ("DLOM").

Background

In January of 1972, the SEC adopted Rule 144 under the Securities Act of 1933. Rule 144 was intended to replace the complex and unpredictable set of rules that had been used in the past and that provided an objective safe harbor for the resale of restricted stock. The adoption of Rule 144 resulted in improved liquidity for restricted stocks. After the initial holding period (two years when Rule 144 was first adopted), the restricted stock could be made available for public sale in compliance with "dribble-out" or volume-limit provisions.

In 1997, the required holding period of restricted stock under Rule 144 was first decreased from two years to one year and, in 2008, the holding period was reduced further to six months. In addition, because of the relatively short holding period, companies selling restricted stock are increasingly selling shares with registration rights. Registration rights typically obligate the selling company to register the shares for resale within four to six weeks. Once registered, the shares are essentially as liquid as any other publicly traded share of the company.

Since its founding in 1991, FMV has been compiling a database of private placements of unregistered common stock issued by public companies. The FMV Restricted Stock Study™ is a database of more than 700 transactions that occurred between 1980 and 2013.

Within The FMV Study, we observed that the impact of holding periods (a measure of liquidity) on discounts was material. The overall median discounts for the two-year, one-year and six-month holding period transactions are 22.1 percent, 15.7 percent and 12.1 percent, respectively. In addition, the median discount for the transactions with registration rights is 13.4 percent, compared to 18.6 percent for the transactions without registration rights.

The Problem

Valuation professionals favor utilizing the most current information in their work, but also information that is most comparable to private companies. Due to the fact that all new transaction data for restricted stock transactions are either for six-month holding periods or six-month holding periods with registration rights, the number of transactions in The FMV Study with shorter initial holding periods and registration rights has gradually been increasing with each quarterly update.

Accordingly, the median discount has been decreasing over time. While the new transaction discounts reflect the increased liquidity of shorter holding periods, there has been no corresponding increase in the liquidity of private equity. As a result, as new data is analyzed, valuation professionals have been struggling with the fact that shorter holding periods and registration rights transactions have reduced the meaningful comparability of current restricted stock transactions with private company equity.

Finally—a Solution

Following years of research and complex analysis, FMV has finally solved this dilemma by isolating that portion of the discount related to the differences in expected holding-period time frames. When FMV initially conceived a Two-Year Equivalent, it appeared to be a relatively simple task, but it quickly became apparent that this was not the case.

Initial analysis led to illogical conclusions because of additional factors, other than the holding period, impacting the discounts. FMV set out to isolate the impact of the holding periods on these transactions by analyzing a set of data with the most similar transaction characteristics occurring in typical conditions.

Through further analysis and many more iterations, FMV has successfully identified several factors impacting the discounts other than holding periods. One of the primary factors impacting the discounts was market volatility. FMV has historically observed that transactions occurring during high VIX periods have higher-than-normal discounts.

Accordingly, FMV excluded all transactions in the top VIX quintile from the data set. The recession had a significant impact on companies in the finance, insurance and real estate industry [collectively Standard Industry Classification ("SIC") code 6XXX]. These companies exhibited characteristics inconsistent with historical trends that impacted their discounts; therefore, all SIC code 6XXX companies were excluded from the data set.

Under the dribble-out provision of Rule 144, transactions including larger percentage blocks have longer effective holding periods. Consequently, larger blocks lead to increased discounts resulting from a greater degree of illiquidity. FMV determined that it was appropriate to exclude all transaction of percentage blocks larger than 20.0 percent from the data set because these transactions are most impacted by block size. In addition, all transactions with premiums (negative discounts) were also excluded. Logically, a knowledgeable investor would rather acquire shares in the public marketplace without paying a premium.

While FMV does not have access to underlying purchase contracts, we believe that many of these premiums may be the result of an investment opportunity not available to other investors or an unidentifiable relationship with the seller. By implementing the aforementioned exclusions, FMV was able to derive a data set of the most similar transactions occurring in typical conditions to be used for the analysis.

Based on an analysis of this adjusted data set, FMV developed appropriate and reasonable adjustments applicable to one-year holding period, six-month holding period and registration rights transactions. Based on the methodology FMV developed, an adjustment factor is added to the traditional discount to convert transaction discounts after 1997 to a Two-Year Equivalent Discount. Transactions with one-year holding periods are increased 3.8 percent, six-month transactions are increased by 5.7 percent and transactions with registration rights, which typically equate to a four- to six-week holding period, are increased by 6.6 percent. These Two-Year Equivalent Discounts reflect the expected discount under the original Rule 144 holding period of two years and make the newer transactions more comparable to private companies.

Summary and Conclusion

FMV's Two-Year Equivalent Discount finally makes current data (six-month holding period and six-month holding period with registration rights) meaningful in the determination of the appropriate DLOM. Two-year holding period transactions are the most similar to private company equity and, thus, most appropriate for comparison in determining discounts for lack of marketability.

As a result, with each reduction of the initial required holding period under Rule 144, questions increasingly arose about the meaningful comparability of the shorter holding period and registration rights transactions to private companies.

By successfully analyzing transactions with generally similar characteristics occurring in typical conditions, and isolating the incremental discount adjustments, FMV has developed a solution to this issue with the Two-Year Equivalent Discount.

Finally, valuation professionals are able to derive meaningful discounts for lack of marketability by using the most up-to-date and relevant information available while, at the same time, maintaining the most meaningful comparability to private companies. FMV expects the Two-Year Equivalent Discount to be introduced into The FMV DLOM Calculator™ during the early part of the third quarter of 2014. ◆

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Endnotes

[1] ***Editors' disclaimer:*** This article presents a new approach advocated by the particular authors. However, readers are advised that there are a large number of alternative methodologies in the valuation profession on quantifying marketability discounts, each having proponents and detractors, positives and negatives. Therefore, until the profession and the courts (for tax or litigated valuation matters) coalesce around a particular method(s) caution is warranted. Also, the authors make the statement that a two-year holding period is most similar to the holding period in private equity. We challenge that assertion and suggest that holding periods differ greatly from one private equity fund or investor to another, with it not unusual to see five to seven year or longer expected holding periods. As always, the valuator must consider the specifics of the matter at hand when determining an appropriate holding period.