The Relationship between the Lack of Marketability Discount and Investor’s Expected Rate of Return

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The discount for lack of marketability associated with an equity interest in a closely held enterprise reflects the difficulty or inability of the transferor to sell its interest based on the fact that there is no established formal market for non-marketable equity interests in privately held entities. The Internal Revenue Service in Revenue Ruling 77-287 acknowledged the fact that a discount for lack of marketability is appropriate when valuing interests in closely-held limited liability companies, limited partnerships and corporations. As a result, this Ruling provides guidance for the valuation of non-marketable equity interests because it acknowledges (1) the increased risk associated with ownership of a privately held interest; and (2) recognizes that investors generally demand higher rates of return or yields when purchasing an equity interest in a private enterprise. Consequently, privately held interests trade at lower prices than their publicly traded counterparts.

In summary, the application of a lack of marketability discount to a non-marketable interest in a privately held entity compensates the investor for the additional risks associated with ownership of a non-marketable interest.

Studies Document Increased Rates of Return Required by Buyers of Non-Marketable Equities and Equity Interests

Three studies have been conducted to measure the increase in return required to compensate investors who hold nonmarketable versus marketable securities. The source for the studies and other information included in this article is the 2014 Discount For Lack Of Marketability Study published by Partnership Profiles, Inc.

Study 1 Private Equity vs. Public Equity Returns

The first study compares the rate of return required by shareholders in private and public companies. To measure the difference, the historical 25 year arithmetic returns realized by investors in private and publicly traded equity investments were analyzed.

For privately held equity firms, the historical returns were measured utilizing the Cambridge Associates LLC U.S. Venture Capital Index®. This index is the official performance benchmark of the National Venture Capital Association. For the publicly traded equity investments, the historical returns were measured using information published by Morningstar, Inc. in Ibbotson SBBI 2014 Classic Yearbook. The aforesaid data indicated that the 25 year long-term return for private equity interests was 20.7% compared to 14.5% for publicly traded small stocks, which is tantamount to an additional rate of return of 42.7% (20.7% - 14.5% = 6.2% ÷ 14.5% = 42.7%).
Study 2 Restricted Stock Returns

The second study examined the increase in return demanded by investors of restricted stocks as compared to the same shares of stock traded on an active public exchange. Restricted stock can only be openly traded for a designated period of time while no restrictions are imposed on its publicly traded counterpart. ¹ In order to measure the rate of return required by owners of publicly traded shares of stock and restricted shares of stock in the same company, the returns for both types of stock were measured by earnings per share as a percent of the market price. Based on 25 transactions in the Johnson Restricted Stock Study published in the March 1999 issue of Shannon Pratt’s Business Valuation Update, the average upsurge between the restricted stock price yield and the publicly trade price rate of return was 29.5%.

Study 3 Long-Term vs. Short-Term Bond Horizons

The third study compared short and long-term government bonds in order to quantify holding period risk. Horizon risk was used as a proxy to measure the increased yield that investors demand to remunerate themselves for increased vulnerability during the holding period of long-term bonds as compared to short-term bonds. For example, while long-term bonds can be sold quickly, an investor must hold the bond to maturity to be guaranteed the recapture of the original investment in the event interest rates rise.

According to the study, the average yields derived from a 20 year treasury bond and 3 month treasury bill over a 35 year period were respectively 7.0% and 5.1% which equates to an anticipated additional rate of return of 37.2% (7.0% - 5.1% = 1.9% + 5.1% = 37.2%). In other words, investors have historically demanded a higher rate of return for the additional risk attributable to an extended holding period.

Quantification of Discount for Lack of Marketability

It is important to recognize that the discounts for lack of marketability are not a black and white issue. There are degrees of marketability that are dependent on the facts and circumstances associated with each valuation.

To quantify an appropriate discount for lack of marketability applicable to a non-controlling fractional interest in a holding entity such as a limited partnership or limited liability company, the appraiser must assess specific dynamics to ascertain the rate of return required by a hypothetical buyer of a closely held equity interest.

Some of the more important factors contemplated by the valuator in his analysis include, but are not limited to, the following factors:

- Estimated remaining term of the entity.
- Anticipated appreciation of the entity’s asset portfolio during the holding period.
- Expected annual income generated by the entity’s assets during the holding period.
- Projected reallocation of the entity’s asset portfolio during the holding period.

¹ Restricted stock is usually issued by a company to raise capital while avoiding the costs of registering with the Securities and Exchange Commission.
• Capital contributions required from investors during the holding period.

• Amounts and frequency of distributions during the holding period.

**Quantifying Rates of Returns Expected by Buyers of Non-Marketable Equity Interests**

Coming up in the March 2015 issue of *BV/Lit Essentials*, our next article regarding the relationship between the discount for lack of marketability (“DLOM”) and investors’ expected rates of return will provide an example of the manner in which Henry & Horne, LLP utilizes market data to quantify the DLOM applied to a non-controlling membership interest in a limited liability company that owns real property.

Comments and questions are encouraged and should be directed to Gary Ringel at garyr@hhcpa.com.

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