Control Premiums in Corporate Valuations

Gilbert E. Matthews, CFA

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SUTTER SECURITIES

GIL@SUTTERSF.COM
1 -415-352-6336

Introduction

The points I will be discussing are:

- Levels of value
- The three meanings of the phrase "control premium"
- Evolving views on control premiums
- The statistical bias in acquisition premium studies and the misuse of control premiums
- How to quantify a control premium
- Control premiums for private companies
- Control premiums for high-vote shares

Levels of Value

Early Version of Levels of Value

Control Value

Marketable Minority Value

Nonmarketable Minority Value

Pratt's Levels of Value

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

Mercer's Levels of Value

Strategic Control Value:
the company's value to a party that could achieve synergistic benefits if it had control.

Financial Control Value:
value without anticipated synergies, but including "the ability of a specific buyer to improve the existing operations or run the target company more efficiently."

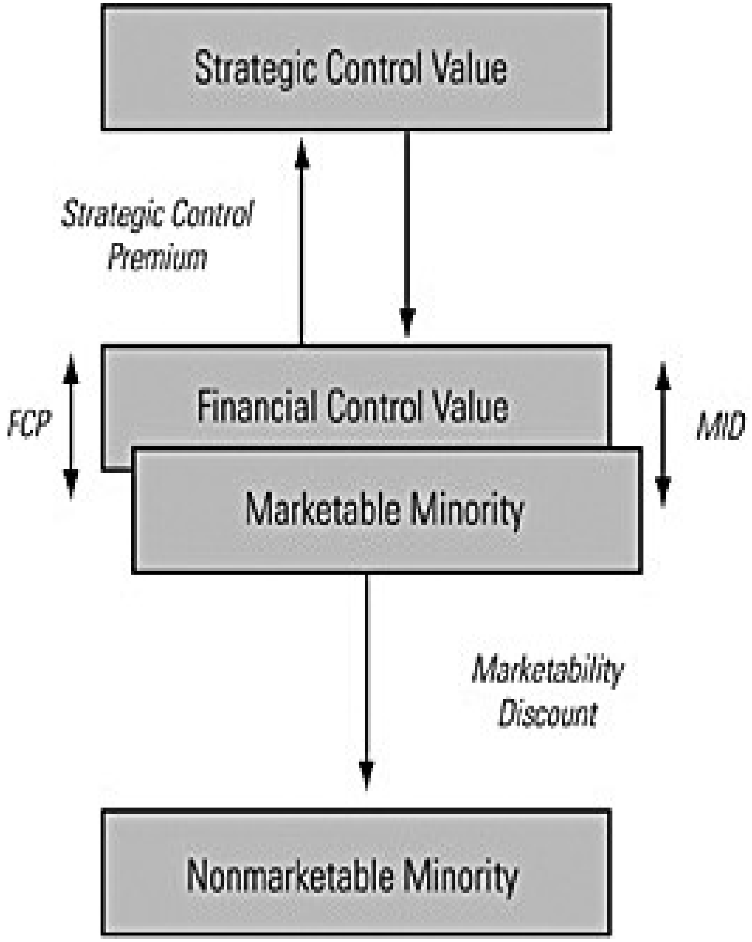
Marketable Minority Value:
market value of freely traded minority shares.

Nonmarketable Minority Value:
market value of illiquid minority shares

Mercer's Levels of Value Chart

Mercer presents his revised levels of value diagram in his book, ***Business Valuation : An Integrated Theory***

It shows Marketable Minority Value over-lapping Financial Control Value.



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

Most Public Companies Trade at Financial Control Value

Mercer explains :

[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."

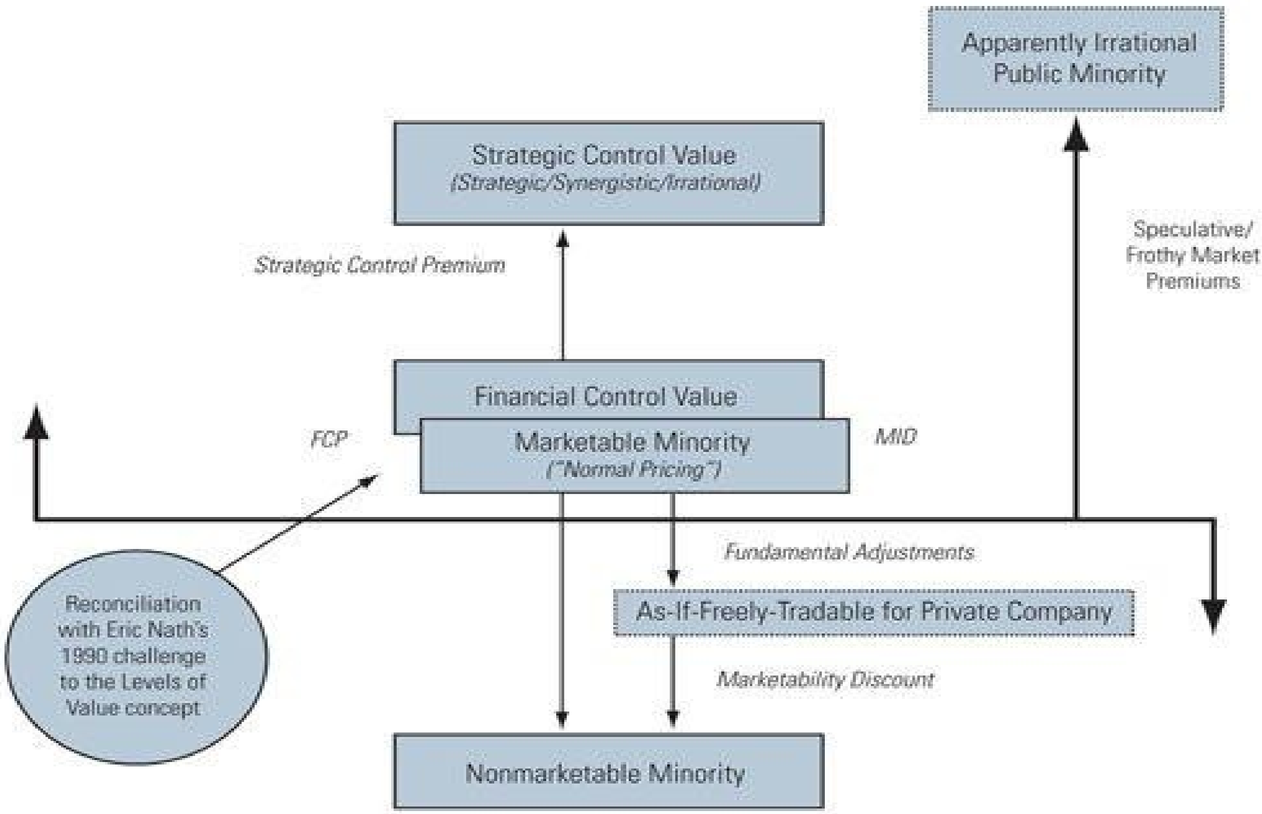
- Mercer and Harms, **Business Valuation**: **An Integrated Theory**, 2nd Ed., p. 81.

Public Companies Can Trade at Above Strategic Control Value

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.

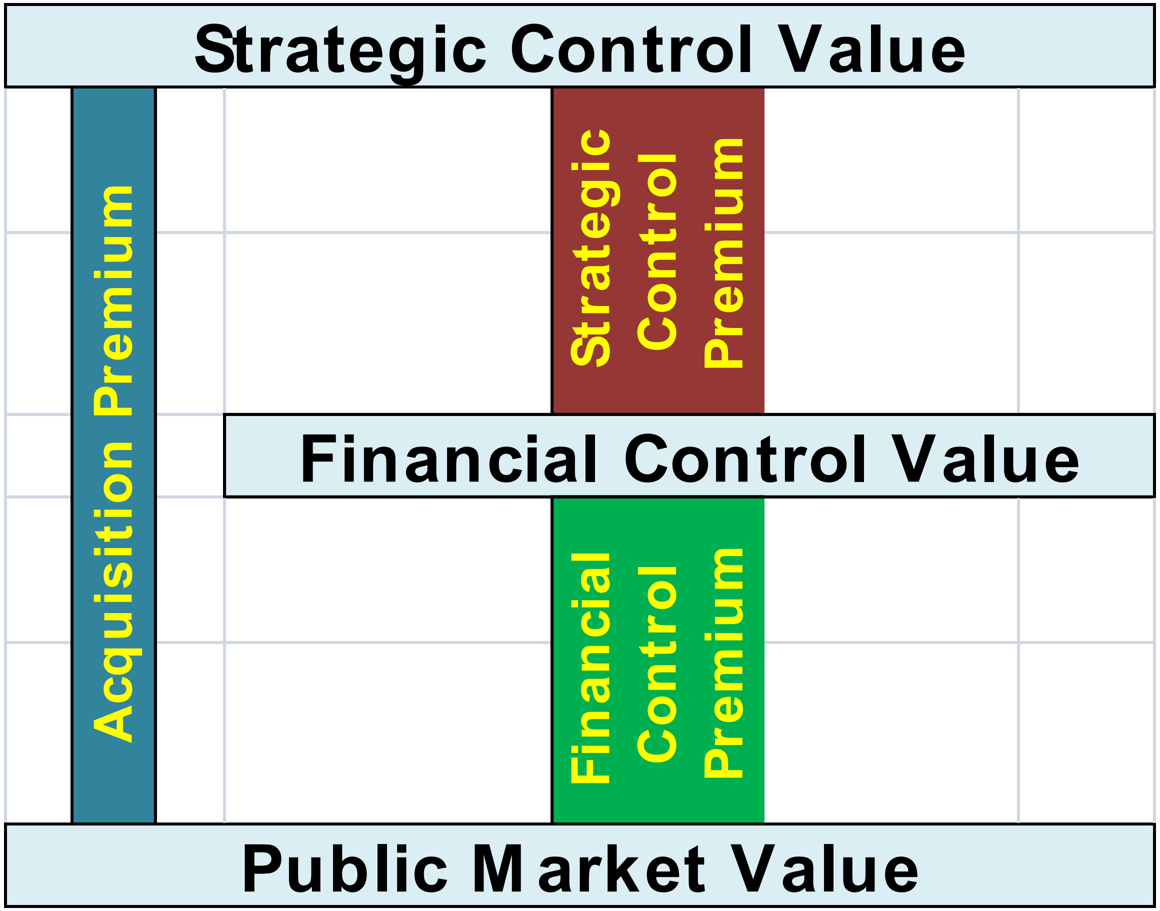
Public Companies Can Trade at Above Strategic Control Value (2)



Mercer, **Business Valuation: An Integrated Theory**, 1st Ed.

The Three Meanings of “Control Premium”

The Three "Control Premiums"



The Ambiguity of the Phrase "Control Premium"

The phrase "control premium with 3 different is used to describe three different concepts.

Meaning #1: Acquisition Premium = Acquisition Premium = difference between Strategic Control Value and Public Market Value.

- Acquisition Premium is the only data point that is directly observable in the market.
- It is the number used in acquisition premium studies.

The Ambiguity of the Phrase "Control Premium" (2)

Meaning #2: Financial Control Premium

= difference between Financial Control Value and Public Market Value

= the inverse of minority discount.

Meaning #3: Strategic Control Premium

= difference between Strategic Control Value and Financial Control Value.

Clarifying the Meaning of "Control Premium"

Ambiguity could be reduced if valuators, commentators, and expert witnesses shared a common language based on a commonly-shared conceptualization.

Evolving Views on Control Premiums

A Pioneering View

Eric Nath's conceptual breakthrough in 1990 was widely criticized at the time.

> *[A]n appraiser could utilize a control premium only if it could be convincingly demonstrated that the comparative stocks being utilized are undervalued, and a reasonable estimate of the magnitude of undervaluation can be established for each stock, individually. This will be theoretically impossible in an efficient market.*

Eric Nath, "Control Premiums and Minority Interest Discounts in Private Companies,"
Business Valuation Review, June 1990, p. 45

Another Early Insight

Another early criticism of the concept that all transactions called for a control premium was published in 1990.

> *Sometimes people attempt to determine the value of a corporation by adding an average acquisition premium to the freely-traded value of a company's common stock. ... This procedure is usually unsound. An acquisition premium is a result of factors unique to each transaction, and of the degree of market undervaluation prior to the transaction.*

Gilbert E, Matthews and M. Mark Lee, "Fairness Opinions & Common Stock Valuations" in ***The Library of Investment Banking,*** Vol. IV, R. Kuhn, ed. (Dow Jones Irwin, 1990), p. 407

The Tide Begins to Shift

In 1993 Professor Bradford Cornell wrote:

> *[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].*

Bradford Cornell, ***Corporate Valuation*** (McGraw Hill, 1993), p. 243.

Pratt Comes Aboard

Shifting from a position expressed in his 1996 3rd Edition of ***Valuing a Business***, Pratt wrote 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.*

Pratt, "Control Premiums? Maybe, Maybe Not – 34% of 3rd Quarter Buyouts at Discounts," *Business Valuation Update,* January 1999, pp. 1-2.

Pratt Comes Aboard (2)

Pratt then wrote in 2001:

> *Out of the tens of thousands of public companies only a small percentage actually are acquired each year. In recent years the companies purchased have often been "best of breed," making them a very unique subset of the market. Statistically, it is unlikely that this small, select group is universally representative of the market as a whole.*

Pratt, *Business Valuation Discounts and Premiums* (Wiley, 2001), p. 60.

Mark Lee's Valuable Insights

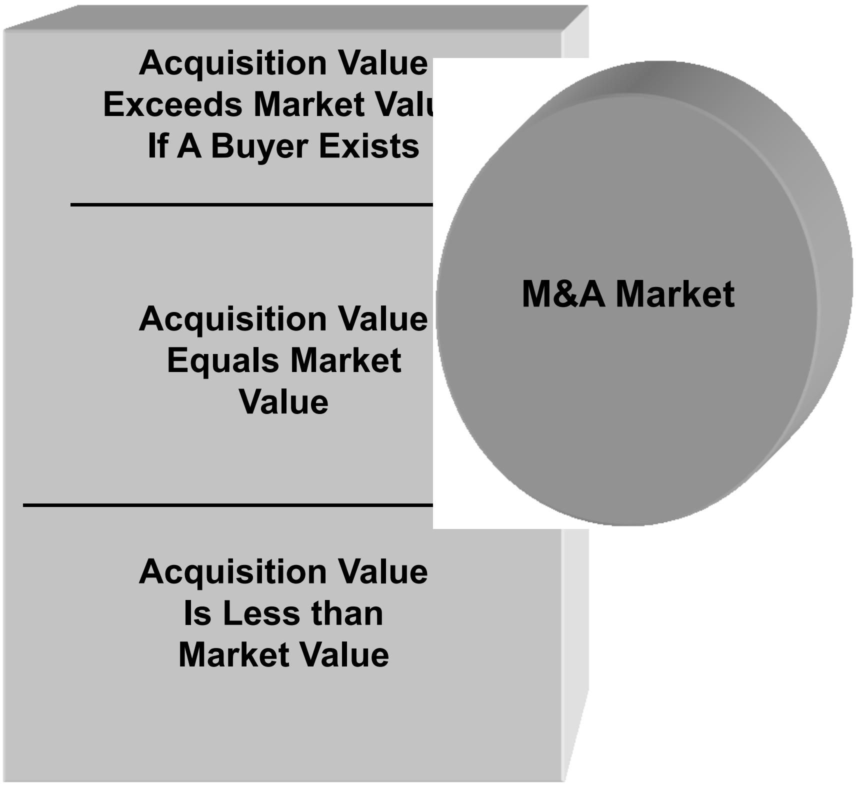
If there is no M&A market available to sell a company at a premium to its stock market value, then there is little or no acquisition premium, much less a "theoretical" premium based on an average of acquisitions of dissimilar companies.

M. Mark Lee, "Control Premiums and Minority Discounts: the Need for Economic Analysis," *Business Valuation Update*, August 2001, p. 4

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.

Mark Lee's Diagram



The Diagram If All Market Prices Were Less than Control Value

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

A Legal Commentator Addresses the Issue – 2001

The legal community entered the fray 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.

Richard A. Booth, "Minority Discounts and Control Premiums in Appraisal Proceedings," 57 Business Lawyer 127, 130 (2001)

*[A]lthough it is always appropriate to ask whether there is some reason to distrust the market price in any given case, it is clear that the market price is not **always** low.* [Emphasis in original] *… Indeed, in 1999 the Wall Street Journal reported several takeovers at negative premiums. Apparently, in the case of these companies the market had risen to a price in excess of control value.*

Id. at. 149.

More Legal Commentary – 2003

[C]ontrol premiums only occur in transactions involving a transfer of control, where there are thought to be gains from trade. . . . Even if all values, both present and potential, are valued in the market price for the firm's shares, one would not expect to find a discernible control premium in a widely held firm that is well managed and appears to offer little probability of a transfer of control. ***Any small probability of a control transaction will already be reflected in the market price,*** *because absent a dominant shareholder, all shareholders expect to have an equal opportunity to share in any such premium, should it appear.* ***Absent an actual transfer of control, control premiums represent probabilities of a control transfer at a premium.*** *Where the probability is close to zero, so is the premium* [emphasis added].

William J. Carney & Mark Heimendinger, "Appraising the Nonexistent: The Delaware Courts' Struggle with Control Premiums," 152 U. Pa. L. Rev. 845, 860 (2003).

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Mercer Concurs with Nath

Mercer, who had initially criticized Nath, came to recognize that Nath was correct.

In the first edition of *The Integrated Theory of Business Valuation* in 2004, Mercer discussed his past disagreement and his current view.

- Mercer's book included the modified levels-of-value diagram that showed Marketable Minority Value overlapping Financial Control Value.

Broad Acceptance

The concept that market prices often include control value is now widely accepted in the valuation community.

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

Philip J. Clements and Philip W. Wisler, ***The Standard & Poor's Guide to Fairness Opinions*** (McGraw Hill, 2005), p. 94.

Misuse of "Average"

Control Premiums

The Fallacy of Average Premiums

"Average premiums" in acquisitions are statistically biased.

Average acquisition premiums includes a substantial built-in upward bias because databases consist primarily of those companies which acquirers believe to be worth more than market price.

> *[T]he universe of guideline transactions includes companies which were* ***undervalued*** *in the market but necessarily excludes companies that acquirors consider* ***overvalued*** [emphasis in original].

Matthews "Misuse of Control Premiums in Delaware Appraisals," *Business Valuation Review,* Summer 2008, p. 118.

The Fallacy of Average Premiums (2)

Professors Hamermesh and Wachter point out the illogic of using average premiums:

> *[I]t is incorrect to make the logical jump that these [acquisition] premiums reflect some kind of [implicit minority discount]. The fallacy is obvious and analogous to the "dogs that don't bark" metaphor: there are lots of dogs, and most of the time, most dogs are not barking. Similarly, in any given year, the vast majority of companies are not involved in a change of control transaction.*

Lawrence A. Hamermesh & Michael L. Wachter, "The Short and Puzzling Life of the 'Implicit Minority Discount' in Delaware Appraisal Law," 156 U. Pa. L. Rev. 1, 33 (2007).

Investment Bankers Often Misuse Average Premiums

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

Many investment bankers include average acquisition premiums as a standard in fairness opinions.

- A review of 346 published fairness opinions in cash acquisitions during two 12 month periods (Sept. 2007 – Aug. 2008 and Sept. 2010 – Aug. 2001) showed that almost half (48.3%) used average premiums paid as a standard of fairness!

Quantifying

Control Premiums

Look at Multiples in Guideline Companies and Transactions

Do not rely on average premiums in other transactions.

In determining a Financial Control Premium, the key factor is the relation between market multiples and transaction multiples.

- quantify Financial Control Premium by comparing multiples of guideline with multiples of guideline transactions.
- if available, examine data for relevant transactions in which large minority interests are acquired.

Financial Control Premium Should Be Supported by Facts

Financial Control Premium should be applied only if justified by specific data

- Without evidence that the prices of guideline companies include minority discounts, there is no reason to apply it.
- However, the market is sometimes inefficient, so that it may arise.

Synergistic Control Premium, if applicable, must be quantified based on judgment as well as an appropriate analysis.

Transactions at Earlier Dates – or Not at All

Adjustments are required for comparing transactions that were priced at earlier dates under different market conditions.

If there are no recent guideline transactions, market prices of guideline companies are probably not at levels that are attractive to acquirers.

- If so, it is difficult to justify any premium.

Control Premiums in Private Companies

Control Premium for Private Companies

Control premium may be determined by reference to multiples of public companies and publicly-disclosed transactions.

Control premium, if any, should be determined in relation to "public market equivalent value.

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Why a Private Company Might Receive a Lower Premium

Possible reasons why a private company might command a lower price than a similar public company include:

- quality of management
- limited availability and/or higher cost of debt financing
- quality of accounting information
- may be less well known to potential investors than similar public company.

Control Premiums for High-Vote Shares

High-Vote Shares May Merit a Control Premium

If a company has both high-vote and low-vote shares, a control premium may be applicable to high-vote class.

- ... but only if the holders of high-vote shares have the ability to transfer their control position.
- In a majority of American public dual-class companies, the value of high-vote shares is limited by a legally binding provision which prevents the sale of control at a premium to the price received by other shareholders.

Market Prices of High-Vote Shares Do Not Indicate Control Value

The relative market prices of high-vote and low-vote shares does not indicate the value of control.

- High-vote shares often have thin markets, and may sometimes times trade at a lower price than low-vote shares because of illiquidity.
- Because a majority of high-vote class is virtually always owned by control shareholder[s], the high-vote shares have no greater value than low-vote shares for minority holders.

Premium for High-Vote Class

The premium for voting control should not be calculated on a per-share basis.

- It should be determined as a percentage of the value of the entire company, which is then allocated to the high-vote shares as a class.

Based on U.S. transactions, premium for high-vote shares is 2% to 3% of equity value.

Summary

Summary

- Distinguish between Acquisition Premiums, Financial Control Premiums and Strategic Control Premiums.
- Understand that actively traded shares often sell at or close to Financial Control Value.
- Recognize that average premiums in other transactions are not a valid measure of control premiums.
- Consider differences in multiples between guideline companies and guideline transactions.
- Use judgment, not formulistic calculations, to determine an appropriate control premium – if any.