Minority discounts

Our earlier articles in the series on valuation issues all refer to the value of a company as a whole. These assess the worth of a company to a purchaser acquiring the business in its entirety.

However, we are often asked to provide a valuation of small tranches of shares; for example, in shareholder disputes, or for the purpose of determining net worth in the case of divorce.

The value of an individual shareholding does not necessarily represent a pro-rated value of the entire business. There are two key factors to consider here:

(i) If the company has a complicated share and debt structure, this may have an impact on the division of the proceeds of any sale of the business between the different classes of shareholders and lenders (and might impact on the ability to sell the company at all); and

(ii) Even if the company only has one class of shares, the sale of a small shareholding (a minority interest) will often attract a discount.

It is this latter factor that we focus on here.

The principal reason behind a minority interest discount is control; a small shareholding conveys less control and influence to affect the decisions and management of the company, and so ultimately is often worth less.

Let us take as an example a situation where 90% of the shareholding of a company is owned by three directors (30% each), and the balance of 10% held by an investor who is not employed by the company. The business generates annual post-tax profits of £100,000. An accountant has helpfully deemed that a P/E multiplier of 5 would be appropriate for the business, and applying this to the business in question a whole-company valuation of £500,000 has been derived. One might expect, then, that our minority investor's shares would be worth in the region of (10% x £500,000 =) £50,000.

However, in our example, the three directors act in unison, and use their majority voting power to decree that the company will not declare any dividends; instead, they vote to increase their remuneration as directors, and the balance of excess cash is reinvested in the business (say, to open a new branch based in Japan – a course of action that the investor does not agree with and considers to be a waste of money). Our investor is left with a shareholding that does not yield any income to him. Clearly, the value of such an investment to a third-party purchaser would be tarnished; a significant minority interest discount would apply here – perhaps as much as 75% of the pro-rated value of his shares.

Notwithstanding that there are certain statutory provisions to prevent prejudicial abuses of power against minority shareholders, this example illustrates how the lack of voting control can devalue the worth of an individual shareholding.

The issue of whether a minority discount should be applied (and, if so, how much) will depend on the circumstances of the valuation and in some situations on the constitution of the company being valued.

In general terms, the greater the shareholding, the greater the control the shareholder could wield, and the lower the minority interest discount to be applied. For example, a shareholder with 25% or more could block those actions requiring approval by special resolution, and therefore might represent considerable “nuisance” value to the majority shareholders. Once a shareholder has more than 50% of the shareholding in a business, he may be deemed to have effective control.

It might also be necessary to consider the level of control exerted by the other shareholders in the company. In a business with 10 shareholders each holding 10% of the share capital, so long as groups of shareholders do not act in concert, then each has equal (albeit limited) control. In a business with three shareholders with holdings of 45%, 45% and 10% respectively, the minority shareholder might have a strategic advantage, as he holds the “casting vote” if the two larger shareholders are unable to agree.

In the context of divorce proceedings both a divorcing husband and wife often each own 50% in a family run business. In theory, both have less than a controlling interest in the company and so to a theoretical third party buyer each 50% stake would be worth less than a straight pro-rated 50% valuation of the company as whole. However, when the potential divorce settlement might entail a transfer of one 50% stake to the other stakeholder, then the 50% stake becomes more valuable to the transferee than the transferor. In such circumstances it may be inappropriate to apply a minority discount.

In the context of a shareholder dispute, the company’s articles of association or shareholders’ agreement (if one exists) may specify what, if any, minority discount should apply in any dispute between shareholders. In these cases, the issue of minority discount is moot.

In others, and as is the case in so many valuation matters, judgment must be applied. Unfortunately, there is limited empirical evidence that can be used as guidance, and instead the level of discount is assessed based on applying experience to the specific facts of the case.