IHS Markit®

Incremental DLOM: A Bridge Too Far?

Matthew Pringle, CPA/ABV, Valuation Analyst | Private Capital Markets

In our last report, we discussed the concept of a discount for lack of marketability (DLOM) and when to use it. We concluded that a DLOM is most appropriate in those cases where public market data is used to mark the value of a private company due to the liquidity differences between public and private companies. In this report, we will build on this knowledge to talk about a concept called "incremental DLOM," how it applies to company valuations and how this concept differs between ASC Topic 820 and 409a valuations.

An incremental DLOM is utilized in those cases where the valuation expert determines that there is a difference between the liquidity of the common stock and preferred stock holdings of a company. In layperson's terms: if the common stock is harder to sell than the preferred—even when taking into account a lower value—the common likely needs an "incremental DLOM" component to address this lack of liquidity.

The application of an incremental DLOM is most easily noted in 409a valuations as this is the last step in the determination of a common stock value. Incremental DLOM as applied to common stock is of the utmost importance for 409a valuations given that these valuations typically involve the actual transfer of common stock ownership (via options or shares). This is where Topic 820 valuations and 409a valuations differ. A good many Topic 820 valuations that we see are done from the vantage point of venture capital/private equity interests for financial reporting purposes rather than the actual issuances of company ownership. These interests also primarily consist of preferred stock thus making the notion of an incremental DLOM as applied toward common equity a moot point. Yet in those cases where common equity shares are part of the holdings being valued, a number of practical concerns arise.

The valuation expert will find in many cases that an incremental DLOM to common after a backsolve is immaterial. Some might argue:

> But most DLOM calculations can fall in the 20-40% range. How can this be considered immaterial?

Those who hold this view would be correct in one regard: a 20-40% DLOM is material and should be applied when actually representative of the underlying interest. However, DLOMs in this range are often calculated in those cases where an interest's value is derived from public market data, not from its own internal stock transactions. To move from a Series Seed Preferred to Common Equity by using any number of the widely used models (restricted stock, Pre-IPO studies, Finnerty Model, etc.) would be to ignore what has already been priced into the Preferred Series. These models are not directly useful if you are starting from the basis of a non-marketable value rather than a marketable one.

One alternative would be to determine those components that would differ between the tiers of stock to arrive at separate volatilities (and thus DLOM calculations) for each tier. Then once the calculations have been completed, take the difference as an incremental DLOM. However, this produces both practical and conceptual concerns. First, a conceptual concern arises as to the segmentation of the volatility calculation. What portion of the target company's volatility would be attributable to the Preferred Series vs. the Common when both exist? What about between two tiers of Preferred Series? Upon consideration, one can see that the separation of any inputs that one might use in separating total company volatility into its component share parts is a fool's errand. These inputs are intertwined in very complex ways; a complexity that is unique to each company. No universal approach is easily born out of this relationship.

Regarding practical concerns, unlike 409a valuations, Topic 820 valuations do not readily lend themselves to effective and efficient access to management. In most cases, the valuation expert does not have complete data for an informed valuation. This is crucial when attempting to calculate unique DLOMs for each round as granular data specific to each round is necessary in order to start towards any meaningful conclusion. Furthermore, most companies will not have financial data readily available from the start of a round until the valuation date (or the start of the next round for that matter). Funding rounds rarely have the convenience of closing as of an accounting close date.

The question that naturally arises is:

> Why not use the next closest accounting date in each case?

When trying to apply an incremental DLOM in a backsolve, the list of assumptions that now have to be made has grown such that the statistical noise is likely to outweigh any benefit and accuracy that you would obtain in performing these calculations. While this might be a good and interesting puzzle for a university setting, we have to face the practicalities of the real world. The scope of such work is far beyond what is reasonable or practically possible (or conceptually relevant) for Topic 820 valuations.

The easiest way to confirm a common stock component in a backsolve valuation is through another valuation approach. The AICPA Accounting and Valuation Guide* establishes this as an appropriate measure for 409a valuations and serves as equally useful here.

"Valuation of Privately Held Company Equity Securities Issued as Compensation; May 2013"

For more information ipreo.com/private-markets or PCMinfo@ihsmarkit.com

272690986-VL-1018