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Apples and Oranges: When to Include Discounts

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In our combined experience within the Private Capital Markets, clients, auditors and valuation analysts can value a company in as many ways as there are companies to value - not all of them correct. This is especially true of the application of a discount for lack of marketability. The DLOM is applied when an ownership interest cannot be sold in a timely manner or when there is no ready market for such assets - a description that applies to virtually any interest that is not traded on public markets. However, confusion arises when transactions related to the target company are considered for valuation purposes (i.e. a Series Seed round used as an indicator of value). Does a DLOM apply here? Or has this already been taken into account in the pricing of the round? It is the aim of this article to demonstrate that a DLOM as applied to equity shares in private companies is not appropriate when utilizing a backsolve approach for ASC Topic 820 valuations.

The AICPA Accounting and Valuation Guide* states that a transaction involving a portion of the company, barring certain exceptions such as majority/minority control and forced liquidation, is an appropriate valuation method. The resulting value is considered a "non-marketable value", meaning that a DLOM should not be applied. The price paid in such a transaction need not derive a lack of marketability either from empirical data or economic models. Investors have already taken this into account when establishing the per share price. Some proponents of a broad-sweeping application of DLOM would do well to reference the industry's accepted practice in this regard. This begs the question:

> If a discount for lack of marketability (DLOM) is not applied in the case of an orderly transaction of the target company, when is a DLOM applied?

Typically, shares that are considered the most marketable are those that are actively traded on public markets. When an investor buys 100 shares of Company X from the New York Stock Exchange, the price paid for those shares is defined as "marketable value". The price includes the highest liquidity and market exposure out of any potential ownership. Conversely, private companies are considered "non-marketable" given that private company ownership is not traded in public exchanges. The private company does not have the same exposure as public companies, thereby limiting its exposure to liquidity and market knowledge for pricing considerations.

Yet in valuing a private company, public companies are often used as indicators. While there are a number of relevant situations for this approach, the one most familiar to a majority of valuations on IHS Markit's Qval platform is the use of the guideline public company method. This is where the DLOM becomes relevant. In any valuation where "marketable values" are utilized as indicators of a private company's value, a discount needs to be taken to account for this difference between the marketable value and the non-marketable value. In short, anything that comes from the public market that is applied to anything not traded in public exchanges needs to be discounted.

A number of different methods are used to calculate this discount which differ primarily on their mathematical assumptions. Fortunately for the average user of Qval, these technicalities will not matter. The platform takes care of all of this behind the scenes. The next articles in the DLOM series will give the reader insight into these calculations, talk about a hotly discussed area known as "incremental DLOM", as well as some of the differences that result in DLOM applications across topic 820 and 409a valuations.

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