



## **Marketability Discounts — Quantifying A Lack of Liquidity**

According to business valuation guru Shannon Pratt, marketability discounts are often among the largest money issues in a disputed business valuation.

Why the controversy? Because, as Pratt said in a well-regarded business valuation publication\*, “Investors cherish liquidity. While they will pay a very large premium in order to have a readily marketable security, they demand a huge discount from what would be a freely tradable value in order to buy into a privately held company.”

“Marketability” refers to the liquidity of the ownership interest under consideration. That is, how quickly and easily can that interest be marketed or converted to cash. A marketability discount applied to the estimated value of a business is designed to reflect the fact that no ready market exists for shares in a privately held company. This differs from ownership shares in a publicly held company because there is a ready market for those shares.

When considering the amount of marketability discount to apply, business valuation experts turn to two empirical resources which offer analysis of market transaction data as guidance in business valuations.

### **Restricted Stock Studies**

Restricted stock studies are based on the precept that restricted stock is identical to stock in publicly held companies except for the lack of marketability inherent in restricted stock. Thus, restricted stock studies attempt to quantify the difference between the sales price of restricted

stock and the sales price of the same stock in the open market on the same date.

Average discounts shown by these studies are typically between 31-36 percent for stock that is restricted for a two-year period.

### **“Pre-IPO” Studies**

“Pre-IPO” studies present data and analysis based on transactions of closely held stocks held prior to initial public offering. Two series of studies, Wilmette Management Associates and Emory, are based on transactions in closely held stocks compared to subsequent transaction in the same stocks in IPOs. Average discounts based on these studies range from 45-55 percent.

Most business valuation experts consider both of these types of studies when arriving at a marketability discount. In addition, they will also consider other factors such as the company’s shareholder income stream, cash distributions and other measures that bear risk, including company size, stability and the timeframe in which the investor will actually get his or her money.

The IRS continues to challenge marketability discounts in cases of gift and estate valuations. The key to a defensible valuation is documentation. Given the fact that marketability discounts can be the subject of so much disagreement, it is important that the valuation professional document the methods he or she used as well as present findings in a clear concise way.

*If you would like to find out more about marketability discounts, contact our office. We would be happy to answer any questions you may have.*

### **Factors Affecting Marketability**

A range of factors influence the marketability of a company, including:

- Restrictions on stock transfers
- Dividend payouts
- Likelihood of public offering or sale
- Size of stock holding
- Buy-sell agreement provisions

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\* *Business Valuation Update*, April 2001, Business Valuation Library Publication, A Business Valuation Resources, LLC.