

Minority Discounts and Control Premiums: When Do They Apply?

When determining the value of an interest in a privately held company, valuers frequently apply control premiums or minority interest discounts. When valuing a controlling interest in a business, a premium may be appropriate to reflect the substantial influence the shareholder exerts over the company — influence that can be wielded to enhance the value of his or her investment.

Minority shareholders, by contrast, usually have little or no influence over business decisions. This lack of control may call for a discount to be applied when valuing their interests.

Applicability Depends on Valuation Method

A popular misconception among users of valuation reports is that a discount is automatically applied to the value of a minority interest and that a control premium is automatically added to the value of a controlling interest. In fact, whether or not a discount or premium is appropriate depends on the valuation method used.

To understand the applicability of discounts and premiums, it's important to recognize that they represent adjustments to a base definition of value. One can't determine whether an adjustment is appropriate until that base value has been clearly defined. Some valuation methods, for example, result in a control level of value. If one of those methods is used to value a minority interest, a discount may be warranted. But if a valuation method yields a minority level of value, then the base value already reflects the minority owner's lack of control, and a further discount wouldn't be appropriate.

Consider, for example, the guideline public company method. A valuator using this method determines the value of the subject company by reference to the market prices of stock in comparable public companies. Because prices of publicly traded stock are based on minority interest transactions, this method results in a minority level of value, so a discount probably wouldn't be applied. If a controlling interest is being valued, however, a control premium may be appropriate.

By contrast, the merger and acquisition method yields a control level of value. Under this method, value is determined by reference to the prices at which entire companies, operating units, or significant interests in companies have changed hands. Because these transactions almost always involve controlling interests, the M&A method produces a control level of value. A discount might be appropriate, therefore, when valuing a minority interest using this method, but a controlling interest probably wouldn't be entitled to a control premium.

Some income-based valuation methods, such as discounted cash flow (DCF), may result in either a control or a minority level of value, depending on how future earnings or cash flow is projected. Under the DCF method, for example, if "elements of control" are included in estimated future cash flow, then arguably the result is a control level of value. In other words, if cash flow is projected based on business decisions that only a controlling shareholder could influence — such as "normalizing" excess owner compensation to increase income — then the value would already reflect elements of control, and a premium would probably be inappropriate.