The legitimateness of minority discounts for lack of control in share transactions

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Abstract

This article aims to give a contribution to the issue of economic ratio of minority discount valuation due to lack of control in the transactions of minority shares, and specifically analyzes the legitimateness of such evaluation. To this end, we define the concept of minority discount for lack of powers and we analyze the economic reasons that motivate its valuation. In particular, we highlight that the reason behind this type of discount lies in the inability of the minority buyer to gain management prerogatives that controlling stockholders have (private benefits of control). Finally, we draw some conclusions on the issue.

Introduction and Objectives

The market value of minority interests in the share capital of a firm hardly ever corresponds to the equivalent pro-rata value of the total economic capital (W). In general, this is due to:

a) "Subjective conditions of negotiation", that is personal, non-strictly economic factors such as the negotiating capacity of individual contractors, possible information asymmetries, and others (desire for prestige, etc.);
b) "Prerogatives" associated with the interest in the share capital that is being negotiated (Zingales, 1994).

As for point b), when the exchanged shares give the buyer control rights over the firm, or are uninfluential in that respect, a deviation can be observed between the market value of shares and the corresponding pro-rata economic value (i.e. "base value").

If the buyer is able to gain control of the firm, the market value of his shares is calculated by adding a given amount to the corresponding pro-rated value of the economic capital, called *majority/control premium*. When participation does not allow the buyer to gain a solid control of the firm, the market value is estimated by deducting a given percentage from the underlying found value; this is called *minority discount for lack of control* ("reduced powers").

This article aims to give a contribution to the issue of economic ratio of minority discount valuation due to lack of control in the transaction of shares, and specifically analyzes the legitimateness of such evaluation.

The article is organized as follows. The following section provides a definition of minority discount and explore the economic reasons for its calculation. Specifically, we highlight that the rationale behind this type of discount lies in the inability of the minority buyer to gain the management prerogatives that his position would require (i.e. "private benefits of control"). In section 3, we draw some conclusions on the topic at stake,

specifically analyzing the legitimateness of minority discount valuation due to lack of control in the transaction of shares.

Minority discounts for lack of control

Minority discount for reduced powers is usually valuated when share value in public held companies (companies with many stockholders) is estimated, as well as in closely held companies (that is partnerships and/or limited companies with a restricted number of stockholders) and family firms, or firms with special management restrictions (such as companies subject to bankruptcy proceedings or whose Articles of Association contain "golden share" provisions), and more in general when shareholding is acquired by individuals that are unable to become controlling shareholders after the acquisition.

Conversely, this type of minority discount should not be calculated when the transferred shares, although absolute minority shares compared to the total capital stock, allow the buyer to impact the firm's management (while not in a dominant way as, if it were so, a majority premium should be calculated) because of:

- The high number of shareholders;
- Factors which may strengthen the vote of the assembly (e.g. the case of shareholder's agreements);
- Corporate governance provisions in the Articles of Association or in the legislation of the country to which the company belongs that protect minority shareholders against "dominant position abuse" from the controlling entity and give the latter the power to influence management policies.

Depreciation of minority interests with respect to the base value is given by:

$$SC_X = C_X W_X$$

Where:

SCx is the value of the minority discount for lack of control (Odegaard, 2007);

Wx is the pro-rated value of the firm's economic capital (*base value*);

Cx is the coefficient (*discount percentage*) that represents the discount value. Under current professional practice the discount percentage is calculated on the basis of the percentage of "control premiums" calculated in previous transactions of majority shares within similar firms (Pratt, Reilly, & Schweihs, 2007; Bae, Kang & Kim, 2002).

The ratio behind this type of minority discount lies in the impossibility for the buyer to access management prerogatives, specifically the right to allocate the firm's resources at his sole discretion (Doidge, Karolyi, Lins, Miller & Stultz, 2009). The so called *control attributes* may include:

a) Psychological, non-pecuniary benefits ("reputational values") pertaining to the controlling position occupied (Masulis, Pham & Zein, 2006);
b) Pecuniary "private" benefits, attributed to the controlling shareholder exclusively and associated with the power to manage the company's assets and direct the cash flows outside the firm (Albuquerque & Schroth, 2010), fully or in part, towards entities controlled by the same controlling owner ("external sinergies");
c) Pecuniary "private" benefits that the controlling shareholder extracts from the firm to his own exclusive advantage (Nicodano & Sembenelli, 2004; Doidge, 2004), which has its counterpart in the equivalent loss to minority shareholders. This might result in an opportunistic accumulation of wealth and even in a looting of the firm's resources ("tunneling").

Type (a) benefits rarely generate the risk of compromising the interests of minority shareholders, and therefore do not contribute to define the class of minority discounts we are investigating. Conversely, private advantages of type (b) – when the subsidiary firm is integrated into a superior business entity controlled by the same shareholder - and type (c) – when firm assets are used by the controlling entity for personal purposes - are intrinsically subject to that risk.

As for type (c) benefits in particular, when the controlling entity extracts pecuniary, private benefits by expropriating the firm's resources at the expense of minority shareholders, it is evident that the profits of investments in risk capital obtainable from the firm's resources is inferior to the benefits obtainable in the absence of such expropriation. In theory, there are two different types of *tunneling*:

1) Various types of misappropriation of firm's assets ("self-dealing") that take place when:
   - Assets are sold at unfairly favourable prices to entities somehow connected to the controlling shareholder (Johnson, La Porta, Lopez De Silanes & Shleifer, 2000);
   - Controlling shareholders that occupy managerial positions inside the company are paid compensations which exceed market prices (Poulsen, 2011);
   - Money is lent under favourable terms to entities connected, directly or indirectly, to the controlling shareholder (Baek, Kang & Lee, 2006);
   - The controlling entity uses assets and/or firm services (amenities such as planes, cars, houses, chauffeurs, ecc.) without adequately paying for them (Luo, Wan & Cai, 2012);
2) One-off forms of assets transfer to the controlling shareholder made without physically transferring the firm's resources, as when insider trading is carried out thanks to one's managerial role, or when assets and/or services are transferred to the firm capital at higher values than the market ones, or when stocks are issued at diluted prices ("diluition") etc.

Considerations

For the main doctrine and the professional practice, if majority premiums measure the surplus value associated with private benefits (both pecuniary and non-pecuniary) that accrue to the control-holder of a given firm, then the lack of such 'privileges, with respect to minority interests, entails a depreciation which, *ceteris paribus*, reflects the decrease in the found value of the interest held.

Nevertheless, in our view, before even discussing the theoretical source of minority interest valuation criteria analysed above, the motivations themselves leading to the calculation of discounts for reduced powers should be debated in the first place, as there is no reasonable, logical correlation with control premiums.

As we know, the market value of an interest, in the lack of subjective conditions of negotiation, of illiquidity situations and of the benefits associated with controlling ownership, should in principle be equal to the underlying found value (pro-rata value of the economic capital), thus reflecting the allocated quota of future cash flows produced by the firm. If, conversely, the amount of interests held is such that the buyer acquires controlling powers over the firm, and consequently extracts the above-mentioned private benefits from his controlling position, then it is legitimate to increase the found relative value by a given percentage, in the form of a control premium. It is, however, illogical to apply a discount (*ad adiuvandum*, quantitatively derived from the above mentioned premium value) to the found value of a minority interest in the absence of such privileges, since its objective profitability is proportionally equal in value to that of the majority interest.

A minority discount for reduced powers would be justified only if the fruition of private benefits associated with the shareholder's controlling power resulted in the

impoverishment of the firm's assets, with consequent loss of profitability and of capital share value outside the controlling ownership. In the usual business management case, that is when the firm's policy is oriented towards creating value and ensuring the continuation of business over time, the presence of pecuniary and non-pecuniary benefits (as when controlling-holder uses the firm's assets for personal purposes) would explain the calculation of a premium at the time of transaction of controlling shares. Still, it would not justify, *sic et simpliciter*, a reduction of the found value of minority shares within the same firm, if there were no corresponding loss of the business' assets.

In other words, we believe that the valuation of discount rates is justified only if the activity of the controlling owner is geared towards asset misappropriation fraud (*tunneling*) to the detriment of minority shareholders. In this particular situation, the "physiological" extraction of private benefits normally associated with the controlling *status* goes beyond normal limits and the firm's economic value may be damaged. This occurs when the controlling holder carries out the following operations:

1) Firm assets spin-off to the benefit of subjects that are directly or indirectly related to the controlling holder not motivated by technical or economic reasons and in any case made at unfair market prices;
2) Income and/or cash flows are transferred to firms that are directly or indirectly controlled by the control-holder through "transfer pricing" processes;
3) The controlled company is used to operate *contra legem*, and the responsibility of such illegal actions falls back on the firm itself.

Besides, the private benefits that controlling ownership extracts can be hindered (or completely impeded) by legal and extra-legal instruments, which may ensure adequate protection to non-controlling stakeholders (Modigliani & Perotti, 1997; Holmen & Knopf, 2003). Examples of legal instruments are:

- The legal environment itself, by which we designate the legal instruments which protect minority shareholders and social creditors from the control-holder's tunneling policies but also the effective enforcement of such instruments by public and private supervising agencies;
- Suitable standards of accounting information (particularly with regard to annual financial statements and consolidated financial statements) to guarantee truthful and correct information about the economic and financial status of the concerned firm as well as of the management operations.

The word extra-legal factors refers to the existence of a moral code in all civilised societies according to which public opinion (minority shareholders, creditors, workers etc.) invigilates the activities and the work of control holders.

Consequently, we assume that in countries where protection (both legal and extra-legal) granted to non-controlling stakeholders is very low, the amount of private benefits that control-holders extract from their controlling position might be significantly high. Majority premiums will also be very high, compared to the found value of controlling shareholding, and minority discount for non-controlling shares will be higher correspondingly (Dyck & Zingales, 2004).

Conversely, in countries where complex and flexible regulations exist to prevent and punish such "looting policies" at the expense of minority stockholders, valuating a discount based on the found value of minority shares would mean, in actual fact, to acknowledge that the control-holder is acting against the law (and against ethical values *tout court*). In such situations, there would be room for complaint to competent authorities and potential buyers might lose interest in the transaction.

However, this very circumstance might represent a grounded motivation for valuating a discount for reduced powers. When such regulations are deliberately ignored or evaded by the controlling ownership (a circumstance that occurs with alarming frequency even in countries with advanced legal systems like Italy), and when the competent authorities' action is slow and inefficient in preventing or sanctioning such unlawful behaviours ("weak enforcement"), the application of a more or less high discount to the minority share found value would be justified to determine market price.

Further research

Additional studies will be required to verify empirically which is/are the methodology/ies used in the European and international professional practice to evaluate minority discount due to lack of control in the transaction of shares.

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