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FAIR VALUE™

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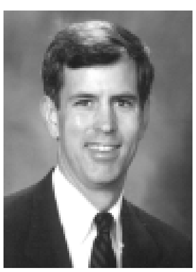
Minority Shareholders- Dividends and Their Crucial Impact on Value (and Why Even 45% Discounts for Lack of Marketability Can Be Reasonable)

By: George B. Hawkins, ASA, CFA

Introduction. The minority shareholder's dilemma is a common one. Consigned to little or no dividends, the minority shareholder may have little or no ability to force the majority shareholder to increase them. The other major way for the minority shareholder to realize a return on his or her investment in the shares is to have those shares increase in value over time, creating the prospect for future capital gain if the company is sold. But what if there is little prospect for the company to be sold to realize a windfall? Suppose the company has been in the family for generations and there is little chance this will change in the future?



George Hawkins

How then is the minority shareholder to realize a return? Answer: only through the actual dividends received. This is the only tangible return the investor knows he or she is likely to receive. Suppose the comparable public companies in the same industry that are used for valuation are very similar in all respects except they pay out a far higher percentage of their annual earnings to shareholders. How should all of these facts affect the fair market value of a minority interest in the private company.

Recent Gift Tax Case in Which Banister Financial Was Involved Addresses These Issues. These were precisely the issues in a recently decided gift tax case in U.S. Tax Court in which George B. Hawkins, ASA, CFA, of Banister Financial, Inc., appeared on behalf of the petitioners to testify as to value of two privately owned companies. Hawkins was hired after a challenge by the Government of an earlier gift return based on a valuation prepared at that time by another valuation firm.

A Proper Focus on Dividend Yield Has Huge Impact on Value. In valuing the two private companies, Hawkins compared ten local or regional publicly traded companies in the same industry to the two private companies. From those public companies he derived multiples for price to latest year earnings, price to 3-year average earnings, price to latest year gross cash-flow, price to 3-year average gross cash-flow, dividend yield or capitalization of latest year's dividends, and dividend yield on capitalization for 3-year average dividends. He compared the dividends paid by the private companies to those paid by the guideline companies, excluding special nonrecurring dividends.

In reaching his conclusion of value, Hawkins gave more weight to actual dividends than to price to earnings and price to gross cash-flow ratios because the private companies had significantly lower dividend payout ratios than the guideline companies. The dividend payout rates (dividends as a percentage of annual earnings) of the two private companies ranged from 12.62 percent to 25.03 percent, which were considerably less than that of other guideline companies, whose dividend payout rates ranged from 27.78 percent to 85.31 percent. Six of the ten guideline companies paid dividends totaling more than 50 percent of their net income. Hawkins testified that a public company that has a much greater dividend payout than the private companies at issue will also have higher stock prices. In other words, an investor looking to buy a stock of a company in the industry has two choices. He can buy the private company's shares which pay out 12% of annual earnings in dividends. Alternatively, he could buy an essentially identical public company stock which pays out 50%. Would the investor be willing to pay the same price per share for the private company, yet realize less than one-fourth the level of dividends? Of course not. As a result, Hawkins placed virtually all of his weight on the findings of the dividend yield approach which resulted in a far lower value per share than would have been found based on the use of the price to earnings and price to cash flow measures.

The Tax Court Found This Was Proper Methodology. The Court agreed, finding in its opinion: "A prospective minority shareholder … would almost exclusively consider dividend yield rather than discounted cash-flow or income capitalization to estimate the value of stock in either of these companies because of the likelihood that he or she could only recoup his or her investment through dividends. Hawkins properly considered dividends to be the most significant factor because they are the principal means by which a prospective shareholder could obtain a return on his or her investment."

A 45% Discount for Lack of Marketability. In deciding the appropriate discount for lack of marketability, Hawkins considered the crucial impacts of the limited avenues available to the minority shareholder to exit the investment in the private company shares. Hawkins concluded, and the Tax Court agreed, that an above-average 45% discount for lack of marketability was appropriate because: (a) the companies have been controlled by the same family for almost a century; (b) the family intended to keep control of the companies in the future; (c) the families have taken steps such as implementing a voting trust, bringing the younger generations into the business, and buying insurance to avoid having to sell shares to pay death taxes; (d) both private companies pay much lower dividends than the guideline companies; (e) there have been no sales of one of the private company's shares and only limited family and insider sales of the other company's shares; (f) the shares of both companies are not registered or traded on any exchange or over the counter; and (g) the shares being valued represent very small minority interests that have no ability to direct the affairs of either company or cause the sale of its assets.

Conclusion. Every valuation situation is unique. There can be unusual circumstances involving minority share valuations where common-sense can dictate the reasonable approach to the application of valuation methods and appropriate discounts. In some situations the facts can necessitate placing heavy weight on dividend-based valuation measures, even though they result in values that are substantially at odds with other valuation approaches. Similarly, circumstances can be present which reasonably dictate the use of an above-average discount for lack of marketability. The key to reaching a supported, unbiased and defensible value relies heavily on the degree to which the valuator fully explores all of the individual dynamics present and what each dynamic suggests about the realistic application of valuation methodologies. ♦

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