



Letters to the Editor

Editor's note: We encourage readers to express opinions, share insights, ask questions, raise objections, and challenge the information that we publish in The Value Examiner. The advancement of the valuation profession depends on your ideas and innovations.

Direct Market Data Method

In "Direct Market Data Method: Value Disparity Issues, Part II" (July/August 2006), author Robert M. Clinger III compares the DMDM to the single-period capitalization method. Regarding the DMDM, he states:

The price to sales multiple was based on transactions in similar privately held companies. Therefore the data are implicitly adjusted for lack of marketability of privately held companies. No further discount for lack of marketability is required.

The author then applies that multiple to the subject company, resulting in what is labeled in Table 1 as "Equite (sic) Value Indication on a Control, Non-Marketable Basis." If the multiple originated from completed market transactions, how can its

application result in a non-marketable value indication?

In Table 2, a discount for lack of marketability is applied to the FMV of invested capital and the result is labeled "Equite (sic) Value Indication on a Control, Non-Marketable Basis."

Obviously, if a discount for lack of marketability is applied, the result is a marketable basis.

I would appreciate your (or the author's) response to clarify my understanding of the article.

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The author responds:

It is important to recall that marketability, in the context of business valuations, relates to the liquidity of the privately held company's shares relative to shares in public companies that trade on an open exchange and, thus, have greater liquidity. Investors can readily turn an investment in publicly traded shares into cash at a known price, as quoted on the exchange, within a matter of days and with minimal transaction costs. Investors in privately held companies lack this ability to easily

convert their investment in illiquid shares into cash quickly with minimum transaction costs. Investors in privately held companies also lack the ability to recognize the expected amount of net proceeds from the sale, due to the absence of an active market for shares in privately held companies.

The Ibbotson data used to build-up a discount rate under the income approach is derived from empirical data of publicly traded companies whose shares are actively traded in a free and open market. Applying a discount rate developed using this data to the cash flow of a privately held company produces a value indication as if the shares were freely traded or liquid—a marketable basis. To adjust for the difference in liquidity inherent in this value estimate and the lack of liquidity of the privately held company, a lack of marketability discount must be applied to produce the non-marketable or illiquid value indication that is appropriate.

Under the direct market data method, the transactions from the IBA database, for example, involve controlling

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interests in privately held companies whose shares are not actively traded on a free and open market. The transactions, then, were based on non-marketable shares in similar privately held companies. As a result, this produces an indication of value on a non-mar-

ketable basis, as the transaction data possess a comparable degree of illiquidity as the subject company being valued.

The degree of marketability or liquidity for a privately held company involved in the transactions in the IBA database is, of course, less than that for a publicly traded counterpart. To arrive at a value indication on a marketable basis, a marketabili-

ty *premium* would be necessary to increase the value from a non-marketable basis to a marketable basis. 

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