Discount for Lack of Marketability (DLOM)

Valuation models, such as based on the discounted cash flow valuation approach or the comparable company analysis, typically assume the perspective of a small minority (usually: retail) investor in a listed, publicly traded stock. - Similar investments in non-listed, privately held corporates tend to come along with higher risk, though: Their valuation approach may have to be adjusted, and a DLOM considered. This, however, is cumbersome to estimate and to apply.

DLOM is a concept indicating an impairment in vallue due to lack of salability: Whereby marketability is defined as the right to sell in an established and efficient capital market within a reasonable time, at reasonable cost and with a minimal effect on price. - Lack of marketability implicitly also includes a lack of liquidity: The ability to swiftly convert an asset into cash without diminishing its value.

A DLOM may be considered when valuing stakes in non-listed, private (e.g. family-held) businesses. It reflects the limited universe of buyers interested in stakes of (much) less than 100 per cent. Whereby even in constellations with minority rights protected, a DLOM-related penalty becomes ever steeper the smaller a stake is. As a matter of fact, even larger minority stakes in privately-held companies may be virtually non-marketable, if the controlling majority shareholder remains the only viable acquirer candidate. This is particularly relevant, for instance, if the management of a privately held business receives shares as part of a compensation package: With the stock not trading, there is neither an external pricing benchmark nor a wider buyer universe avail.

Only to a lesser extent does the DLOM indicate an additional return an investor may demand for holding a stake in a privately-held vis-à-vis a publicly traded firm. Whereby that could actually be justified with privately-held companies tending to be smaller in size than public ones, therefore also more exposed to certain risks (e.g. access to capital, management depth, customer concentration, liquidity). Such risks decrease though, with a private firm´s size and its capitalisation increasing.

Instead, next to the cost of both, going public (i.e. via an IPO) as well as those associated with maintaining the listed status of a company (e.g. investor relations, regular filings and disclosures), the DLOM foremost illustrates the reduced universe of buyers available should an investor wish to exit.

Hence, the risks associated with lack of marketability are lesser related to depressed expected earnings or cash flows. Instead, the DLOM reflects an investor´s (limited) bargaining power when aiming to divest: According to the concept, an estimated enterprise or equity value would simply be reduced by the percentage of the DLOM. Whereby assessing the appropriate and applicable DLOM in a valuation context is cumbersome, as it turns out to be a rather qualitative than numerical parameter.

One approach in estimating a DLOM is comparing companies´ stock prices pre-IPO vis-à-vis their (later) IPO prices. Such fluctuate widely over time, though. – Alternatively, put-based option models could be applied, as the value of the right to sell an underlying asset indirectly approximates a DLOM. Using this methodology poses problems as well, though: For instance, as volatility in public markets increases, the risk of holding a private security may increase even more, resulting in a steepening of the DLOM.

For CFOs involved in acquiring stakes in privately held companies on an ongoing basis, following may be considered when applying DLOMs:

- Formulation of a valuation policy: Steepness and application of a DLOM depends – among others - on an underlying company's financial condition and lifecycle/time to exit, providing a "reasonable" level of flexibility.
- Assessment of the private company's condition: If an underlying private company is more closely mirroring its public counterparts through acceleration of financial success and it approaches a condition where an IPO is feasible, then the DLOM should decline over time.
- Consideration of the private company's capital structure: If, for instance, a private company had a complex capital structure, then common stock may be less marketable than preferred stock. Therefore, a higher DLOM may be applicable to the common stock vis-à-vis its preferred stock.
- Reflection on the valuation approach: A DLOM may not be applicable or require adjustment, if, for example, a company has recently raised capital. Provided that capital raised is used to imply a valuation benchmark of the company, some marketability may already be embedded in the private company valuation.

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	DISCOUNT FOR LACK OF MARKETABILITY (DLOM)	
	DECREASING	INCREASING
SIZE OF STAKE	SIZABLE	SMALL
PROTECTION OF MINORITY RIGHTS	HIGH	LOW / NONE
TRANSFER RESTRICTIONS	NONE	SEVERE
HORIZON TOWARDS POTENTIAL IPO	EXPECTED SOON	NONE
BUSINESS RISK	LOW	HIGH
DIVIDENDS	PAID	NONE
OWNERSHIP CONCENTRATION	LOW	HIGH
BUYERS POOL	SIZABLE	SMALL

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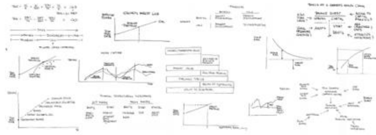

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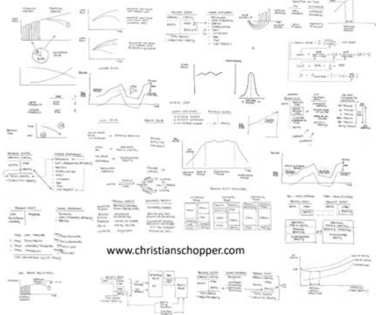

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