Discount for Lack of Liquidity (DLOL)

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. When selling larger blocks of shares into the public market though, a DLOL may have to be applied.

Whilst the concept of a discount for lack of marketability deals with trades in stakes of privately held, non-listed firms, the DLOL refers to transactions of sizable share packages of companies quoted on exchanges.

In a liquid market, trading smaller amounts of shares will usually not have any (major) impact on price, as such volumes are quickly and efficiently absorbed by market participants. This may change, though, if larger share packages are sold.

To start with, the term liquidity describes the ability to swiftly convert an asset into cash without diminishing its value. Whereby several parameters define a market´s liquidity:

- Tightness: Wide buyers universe resulting in a narrow bid-ask spread (i.e. low financial cost of completing a transaction).
- Depth: Ability to absorb large volumes (with no impact on quoted prices).
- Immediacy: Only brief period of time required between trade placement and its execution (of a large order at a given price).
- Resilience: Market´s ability to return to its initial state after liquidity has been consumed (correcting order imbalances which tend to move prices away from fundamentals).
- Breath: A market´s ability to satisfy larger order volumes with minimal impact on prices and when the price impact of large orders occurs at greater volumes.

Should a market get flooded with shares of a certain stock, then usually this imbalance will result in the respective share price decreasing, as the increase in supply is not matched by a corresponding increase in demand: The seller will be forced to take a significantly discounted cut per share.

To minimize such disruptions in the price finding mechanism of a market, an investment bank may be mandated by the seller of a larger volume of stock. In the course of a block trade – which is a privately negotiated transaction -, larger packages of a publicly listed stock are broken up into smaller orders and subsequent trades executed outside the open market. What is in essence a private placement to pre-selected investors and institutions, such structures are also quite common in executing secondary offerings.

Nevertheless, to get them done, block trades are usually executed at a discount, a widened bid-ask spread. And, recent transactions of this sort provide guidance for estimating DLOLs, which can vary widely, though, depending on a specific stock´s trading volume or its volatility.

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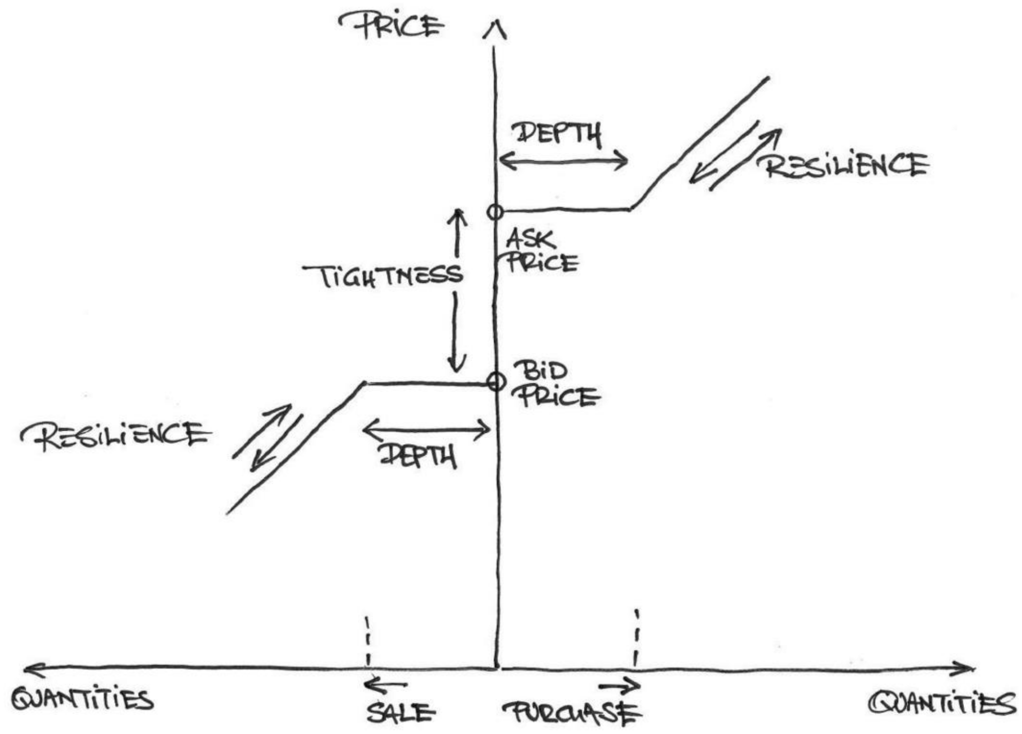

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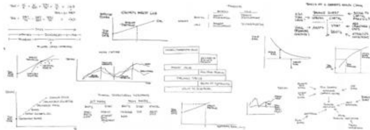

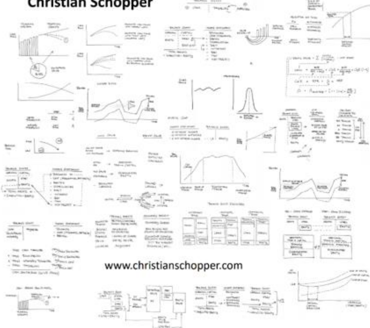

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