

# Issues and challenges in valuing Minority Shares under the Articles of Association<sup>1</sup>

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## Introduction

Minority interest valuations are often required due to sale of shares under the Articles of Association which can be voluntary or forced, for example due to a shareholder dispute. However, a minority interest is often worth substantially less than the pro-rata value of a Company as a whole because of the value of control. The challenging question is by how much? And how does the current economic climate affect the issues to be considered in determining the value of a minority interest? As such whilst valuations generally involve subjective judgement, minority interest valuations can be considered to add additional challenges.

This article considers the issues in ascertaining the value of a minority interest when assessing the value for the whole business and taking a discount for lack of control.

## Methodology

Whatever method is used to value the minority interest, two key determinants of value need to be considered (i) an appropriate maintainable earnings or income stream; and (ii) a multiple or discount rate. In doing so, it is critical to understand the value drivers of the Company and the specific risks factors to be able to make the appropriate adjustments to one or other of these (or both).

## Earnings

Value comes from the ongoing cash-flows, and the realistic maintainable earnings of the Company need to be ascertained.

In the situation of valuing a minority interest how would you treat, for example: excessive remuneration; personal expenses going through the accounts; refusal of the Company to pay dividends? The question here is should you adjust the cash-flows to a controlling cash-flow and take account of the issues in a minority interest discount

or is it more reflective of reality to use a minority interest cash-flow with no adjustments? In using the latter approach, no control-type adjustments are made, and the resulting cash flow is considered to be on a minority level basis. The rationale for this approach is that the minority shareholder does not have the attribute of control to determine matters such as remuneration policy and therefore, the cash flow available for distribution to the minority shareholder (the income stream that is being valued) should not be adjusted for, say, excessive remuneration. This may then avoid the need to consider the minority discount.

Whilst it may be possible to evaluate historic performance, future income is the driver of value. Forecasts needs to be closely scrutinised and can it be assumed given recent events in the economy that steady stable growth is a reasonable assumption?. In assessing minority interest valuations, particularly where there is a dispute, both parties may have quite different views of the future.

Often minority interest valuations are in respect of a shareholder leaving a business and the date of the valuation is critical – valuations are usually based on what is known or knowable as at the date of valuation but is it appropriate to adjust forecasts to take into account events which have occurred since that date? For example a major customer may become insolvent shortly after the valuation date. Can we assess that the risk exists as at the valuation date but the event had not occurred?



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## Assessing multiples and discount rates

In assessing an appropriate multiple it is important to highlight the importance of the valuation date. Different valuation dates can produce dramatically different results. Using Guideline Public Companies in order to arrive at a suitable multiple for the Company under review should best reflect the current market conditions and expectations. However it may be argued a volatile and uncertain market may be unfairly depressing the value of an income generating company. Is it fair to benchmark value based on a market suffering from a lack of capital and low appetite for risk when the Company has no plans to sell or float in the near future. Obviously this requires careful analysis of the specific Company and the specific market conditions relevant to that Company at the valuation date.

As an example of the difference timing can make; the PE ratio of FTSE 350 Support Services group changed from a mean of 18 and median of 17 to 12 and 13 respectively between 22 January 2008 and 21 January 2009. In addition the value of this same group moved by 53% between March and October of 2009.

A discounted cash-flow ("DCF") can be the best methodology to take account of market volatility and management's expectations of growth and decline - provided the necessary information is available and provided the Valuer can be satisfied the forecasts are reliable. Discount rates also change over time though. For example the Equity Risk Premium ("ERP"), which is a key component of a discount rate calculation, changes dependent on the market's perception of equity risk; according to Professor Damodaran the ERP in the UK jumped to 6.51% from 4.20% between 1 January 2008 and 1 January 2009. Although this may not be considered to be the long term ERP rate, it is an indicator of the difficulties in assessing valuations at a moment in time.

Comparable transactions can be a good guide as a source of multiples to help assess the value of minority interests but transactions of minority interests in similar companies with sufficient publicly available data to analyse are invariably difficult to find. In addition, current market conditions may further limit the reliability of this

methodology at present as there are few transactions and potentially some are due to financial distress. Without information it may not be possible to conclude they were completed at fair value.

## Minority discount

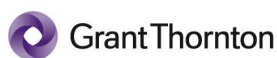
Having arrived at a value for the whole Company, the Valuer will have to either directly or indirectly consider the issues which determine what might be an appropriate minority interest discount.

There are a range of factors that should be considered in determining the discount and they include inter alia: the percentage or size of block of shares held; right to appoint directors; legal issues including voting rights; ability to influence the business and key economic considerations such as the financial condition of the Company and what is the likely return to the minority shareholder. A key factor that Valuers should also consider is the identity of the buyer and the relative shareholdings in the Company.

There is no firm rule as to the level of discount – there are a number of empirical studies that consider the issue of minority interest discounts but they can not be used without consideration of the specific circumstances. Many studies are also based on the logic that the discount for lack of control is the mirror image of the control premium rather than looking at the issues of minority interest discounts in their own right.

## Conclusion

So what is an appropriate discount for a minority interest in a private non-marketable company? The answer depends on the individual circumstances of the subject Company and the primary rule to remember is that each case is unique. Valuations are affected by a range of considerations, and the impact of any single influence will be different from one company to the next. This article raises some of the questions Valuers should consider when determining the value of a minority interest but the answers will always lie in the individual situation and the current economic climate has only enhanced the significant level of judgement required.



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## Contacts:

**Michael Thornton**  
Partner, Valuation Services  
T +44 (0) 20 7728 2644  
E [michael.j.thornton@gtuk.com](mailto:michael.j.thornton@gtuk.com)

**Sheenagh Mckillop**  
Manager, Valuation Services  
T +44 (0) 20 7865 2239  
[sheenagh.mckillop@gtuk.com](mailto:sheenagh.mckillop@gtuk.com)