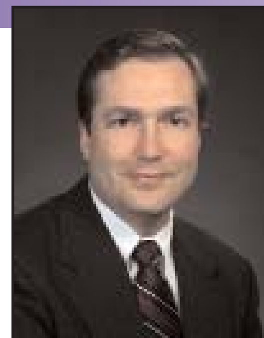
The Direct and Indirect Methods of Valuing Minority Interests Using the Income Approach



HAROLD G. MARTIN JR.,
CPA/ABV, CFF, ASA, CFE

Keiter, Stephens, Hurst,
Gary & Shreaves. P.C.
Richmond, VA
Hmartin@KSHGS.com

When valuing a minority interest using the income approach, there are two methods commonly used in practice: the "direct method" and "indirect method." As with many issues in valuation, this is another area where there are differing schools of thought on which method is more appropriate. However, for the reasons discussed below, the direct method is more appropriate in most instances.

In using the direct method, no control-type adjustments are made to the economic income, 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 compensation policy; therefore, the cash flow available for distribution to the minority shareholder (the economic income stream to be valued) should not be adjusted for compensation. Use of this method eliminates the need to deduct a lack of control ("LOC") discount.[1]

Alternatively, if the "indirect method" is used, control adjustments are made to the economic income stream and the resulting cash flow is considered to be on a control-level basis. If the subject interest is a minority interest, in order to derive a minority level value, a LOC discount must be deducted. The most common source of the empirical data used to determine the LOC discount when using an income approach is the Mergerstat Control Premium Studies. This Mergerstat data presents the control premiums paid by buyers to sellers in M&A transactions. This premium is then converted to an LOC discount using a mathematical formula.

However, there are potential problems in using the Mergerstat data for this purpose. For example, many of the transactions are synergistic transactions. This means that in addition to the existence of a control premium, there is also a synergistic premium imbedded in the transaction price. Generally, the two types of premiums cannot be segregated. It is primarily for this reason, as well as the fact that the direct method produces a result specific to the subject company being valued, that the direct method is generally the more preferred approach.

Having said this, when valuing a minority interest, the economic income stream is often calculated on both a control and minority level basis. An example of when this may be required is if you are using alternative valuation approaches (e.g. market approach) and for purposes of assessing comparability, you need to present the subject company's income statement on a control-level basis.[2]

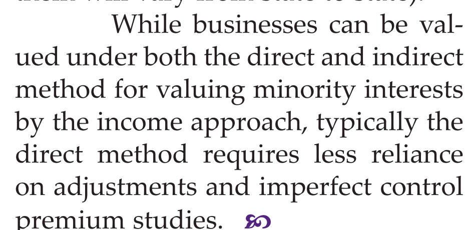
There may also be certain instances when, because of the facts and circumstances, you must calculate a control level value and then deduct an LOC discount using the Mergerstat studies (warts and all). For example, this may be appropriate where the controlling owners in the subject company extract all cash such that there is no cash flow available for distribution to the minority shareholder. The value to the minority shareholder is not $0, as the shareholder can bring a shareholder oppression suit and demand fair value. (Rights of shareholders and the legal remedy available to them will vary from state to state).[3]

While businesses can be valued under both the direct and indirect method for valuing minority interests by the income approach, typically the direct method requires less reliance on adjustments and imperfect control premium studies. ൈ

[1] James R. Hitchner, ed., *Financial Valuation: Applications and Models*, 2nd ed. (New York: John Wiley & Sons, Inc., 2006), p. 103.

[2] Shannon P. Pratt, *Valuing a Business - The Analysis and Appraisal of Closely Held Companies*, 5th ed. (Chicago: Irwin Professional Publishing, 2008), p. 132.

[3] Gary Trugman, *Understanding Business Valuation*, 3rd ed. (New York: American Institute of Certified Public Accountants, 2008) p. 190.



expert TIP

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