

## FACTORS INFLUENCING PREMIUMS AND DISCOUNTS FOR CONTROL IN ASSESSING THE VALUE OF A BUSINESS

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**Abstract.** The issues of establishing the amounts of premiums and discounts for control in determining the value of a shareholding and the factors influencing this are among the fundamental problems of business valuation. This is due to the fact that the amount of control premium can significantly affect the market value of an evaluated business or a shareholding.

The relevance of this paper lies in the fact that the results obtained in the course of the study can be used to further deepen the understanding of the influence of the degree of control on the valuation of a business (valuation of a shareholding), its characteristics, and factors affecting the size of the control premium. This contributes to the improvement of methods for assessing the value of companies in emerging investment markets, including the Latvian market.

The research methodology used in this paper starts with a literature review to shed light on main controversial issues of the phenomenon stressed out in the previous studies. Due to empirical nature of the paper, generally accepted methods of economic research were used including comparative analysis and synthesis. Thus, the methodological basis of the study is the analysis of the literature sources, synthesis and comparison of statistical information.

The purpose of the paper is both to determine the factors affecting the amount of a control premium and to analyse their magnitude, using data from empirical studies conducted in this area by various authors for the period from 1968 to 2018. Therefore, the analysis aims to address the issue of determining the volume of premiums and discounts for control when assessing the value of a business. The conducted study has shown that a premium for control can significantly increase the value of a business or a shareholding being sold (by 7% - 82%). At the same time, the lack of control leads to the application of discounts when assessing the value of a business and their size can also vary from 7% to 82%.

The authors' recommendations are addressed to business owners in emerging markets and are aimed at focusing efforts towards improving key indicators that affect the value of a possible control premium. These are such indicators, as: the degree of concentration of the share capital of the evaluated company; the financial status and financial performance of the company; making use of differences in country legislation governing shareholder rights; the presence of competition for the purchase of a particular company; the presence of a system and voting procedure established in the company.

**Keywords:** *premiums, discounts, factors, control, shareholding.*

**JEL code:** G32, G34

### Introduction

In the modern economy, discounts and premiums are the most important tools used by analysts in assessing the value of a business, as well as in mergers and acquisitions (M&A). Rid et al (2007) note that acquisition is a general term used to describe the transfer of ownership, while merger is a term describing a procedure that may or may not follow the acquisition, but the valuation is done anyway. Therefore the issues of establishing the amounts of premiums and discounts for control in determining the value of a shareholding and the factors influencing this are among the fundamental problems of business valuation. This is due to the fact that the amount of control premium can significantly affect the market value of an evaluated business or a shareholding.

The relevance of this paper lies in the fact that the results obtained in the course of the study can be used to further deepen the understanding of the influence of the degree of control on the valuation of a business (valuation of a shareholding), its characteristics, and factors affecting the size of the control premium. This contributes to the improvement of methods for assessing the value of companies in emerging investment markets, including the Latvian market.

The premium in M&A transactions is the excess of the transaction price (the amount actually paid by the buyer for the item) over the fair market value of the item at the date of the transaction. Among the most used and widespread premiums and discounts, one can single out those that are directly related to the presence or absence of a certain level of control.

Control in general can be characterized as “the right to participate in management and determine company policy” (Pratt, 2007). The degree of control that a particular shareholding provides can range from 100% control to no control at all, with only a small stake in a company's capital. Therefore, premiums associated with a high level of control, or discounts, due to its insufficiently high degree, depend on the type or amount of control powers that belong to a particular shareholder.

To determine the amount of the premium and discount, it is firstly necessary to determine a reasonable base value to which they can be applied. This base, as a rule, is either the value of a controlling interest or the value of a liquid minority interest. Recommended premiums and discounts are usually applied at the very end of the business valuation process. When assessing the value of a business, control premiums or discounts are usually determined prior to premiums and discounts for liquidity. As a rule, this happens because the degree of control, or lack of it, to one degree or another, affects the company's liquidity.

In each specific case, the amount of premiums and discounts for control depends on many factors specific to each type of business, for example: internal features - such as a proportion of the evaluated shareholding, a degree of share capital concentration, a voting regime, and external ones, for example, a legal form of a business or legal restrictions.

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### **Literature review**

In the study “The Role of Premiums and Discounts in Business Valuation: Evidence from the Italian Context” O. Ferraro и F. Rubino (2017) summarized the results of 26 empirical studies to determine the average values of premiums and discounts used in business valuation in professional practice for various periods of time, starting with the study by M. Gelman for the period 1968-1970 and ending with the study of M. Bigelli and E. Sapienza for the period 2000-2003. This review showed a wide range of average premiums and discounts - from 7% to 82%, which is explained by the difference in the valued shareholdings depending on the industry, the phase of the economic cycle and other features of the valued transactions. As will be shown in the second section of this article, the price of control premiums can be significantly higher. Estimating the value of premiums and discounts, one can draw a conclusion about their importance for determining the final price of transactions.

In their studies, these and other authors who analyse control premiums point to various aspects of this topic, both from a particular country perspective (Ferraro, Liberatore, 2016) and from a theoretical perspective. Thus, in their works, T. Nenova in 2003 (Nenova, 2003), as well as A. Dyck and L. Zingales in 2004, indicated that the significance of control and the control itself are higher in countries where in the event of companies acquisition a supremacy of law, protection of minority shareholders, high quality of accounting exist (Dyck, Zingales, 2004).

Ferraro un Rubino (2017) in their study cite the Italian team of authors Zanda et al. (2013), who, characterizing control, note that “control awards are a recognized plus to the value of an investment compared to the corresponding portion of the total economic capital, for the simple fact of allowing the control of a company.”

In the regularly conducted "Mergerstat Control Premium Study" (Mergerstat Control Premium Study, 2018), the data from which are also used by the authors of this paper, it is noted that the control premium is defined as “the additional consideration that an investor would pay over a marketable minority equity value in order to own a controlling interest in the common stock of a company”.

The definition of premiums and discounts is not as straightforward as it might seem at first glance, since different categories of investments to be evaluated can be identified (Ferraro, Liberatore, 2016), as well as different corporate governance models in which surcharges and discounts should be applied.

Over the years, such authors as M. Barclay and G. Holderness (Barclay, Holderness, 1989), L. Zingales, (Zingales, 1995), A. Dyck (Dyck, Zingales, 2004); M. Massari M., V. Monge, V. and L. Zanetti (Massari et al., 2004); P. Hanouna P., A. Sarin, A. Shapiro, (Hanouna et al., 2001); G. Nicodano and A. Sembenelli (Nicodamo, Sembenelli, 2000) in their analytical and empirical studies addressed such fundamental questions as:

- quantitative determination of premiums in different countries, taking into account various kinds of subjective assumptions;
- development of methods for determining the value of premiums;
- factors influencing premiums taking into account different types of acquired shareholdings.

The problem of increasing the value of a business in an emerging market is associated with many quite diverse aspects (Abramishvili et al, 2019), therefore, according to the authors, the solution to this problem should be systematic, taking into account the aforementioned aspects. The cost of transactions is significantly affected by changing stock market indices (Cekuls, Koehn, 2019). Thus, the authors of this paper took into account that in modern conditions, the evaluation of transactions (including control premiums) for mergers and acquisitions of companies occurs, taking into account the existing positive experience obtained in mergers and acquisitions, (Saksonova, Kantane, 2016) as well as the active implementation of progressive fintech technologies (Kuzmina-Merlino, Saksonova, 2018). In the emerging market, banks are the most advanced in this sense. Under the influence of supervisory authorities, they are constantly in the process of improving their management of capital (Konovalova, Caplinska, 2020) and assets (Saksonova, 2013), including in order to comply with Basel III requirements. The higher the internal awareness of an organization, the higher is the level of control (Cekuls, 2016). This has a positive effect on the value of the banking business and M&A transactions in this industry. The increase in business value is directly related to the increase in the turnover of companies. To increase turnover, any company must study the behaviour of its consumers (Batra et al, 2018a), while any company must stimulate its own sales by shaping customer behaviour (Batra et al, 2018b). Development and stimulation of investment activities of the companies is also aimed at increasing the value of a business (Ivanov et al, 2018), and especially it is important in emerging markets (Ivanov et al, 2019). All this creates the preconditions for effective business management, which has a positive effect on the level of control in the company and the value of the control premium.

## **Research results and discussion**

### **1. Factors affecting the rate of the control premium**

The rate of the control premium can depend on many different factors, and its rate varies greatly depending on the combination of facts and circumstances associated with a particular company and specific shareholders (Pratt et al, 2000). The importance of each factor can vary greatly from company to company, from transaction to transaction.

Having analysed the literature on this topic, the authors identified the following most important factors affecting the control premium.

- *The presence or absence of certain elements of control in the shareholding.* Shareholders with shareholdings with different specific weight have different rights and powers, which determines the value of the control factor. The main elements of control (Pratt, Reilly, 2000) include:
  - the right to appoint or change the members of a management team and the board of directors;
  - to determine the amount of remuneration for top managers;
  - to determine the current and strategic policy of the enterprise;
  - to change the direction of business development;
  - to acquire, lease or liquidate business assets, including non-current assets;
  - to select suppliers, sellers and subcontractors;
  - to carry out negotiations and do acquisitions and mergers (M&A);
  - to dissolve, sell or recapitalize the company;
  - to sell or purchase securities, including treasury bonds;
  - to register shares of a company for an initial or secondary public offering.
- *Degree of share capital concentration of the company under evaluation.* When analysing its structure, the following conditions should be taken into account:
  - an increase in the number of shares in a shareholding increases the advantages of the owner of the shareholding (the quantity factor), and the enlargement of one of the minority shareholdings leads to a decrease in the advantages of similar shareholdings (the factor of redistribution);
  - the combined shareholdings have advantages equal at least to the sum of the advantages of each of the combined shareholdings (combination factor);

- an increase in the number of insignificant minority shareholdings in the absence of a majority shareholding in the evaluated company leads to a decrease in the total premium (dispersion factor), and the approach of two or more shareholdings to the size of the majority shareholding intensifies competition and increases the advantages of insignificant minority stakes (competition factor).

As a rule, the following forms of share capital distribution or its concentration are distinguished: dispersion (each shareholder owns no more than 2% of shares); low concentration (no shareholder owns more than 10% of shares); medium concentration (shareholders have stakes from 10% to 25% of shares); high concentration (several shareholders own from 25 to 50% of the share capital) and ultra-high concentration, in which one shareholder owns more than 50% of all company shares (Raeva, Kovalev, 2007). The amount of the control premium depends directly on how the share capital is allocated in the company and on how the evaluated shareholding is combined with other shareholdings.

- *Financial status and financial performance of the evaluated company:*
  - an increase in the turnover (revenue) of the company being the target of purchase or acquisition has a positive effect on the amount of the premium; an increase in market volume has a positive effect on the value of the premium; the ratio of equity to assets negatively affects the value of the premium (Rhoads, 1987);
  - the degree of financial leverage, liquidity and potential increase in the value of assets have a positive effect on the value of the premium (Crawford, Lechner, 1996);
  - the return on equity of the company being purchased or acquired has a positive effect on the value of the premium (Rose, 1987);
  - the ratio of growing debt to assets negatively affects the value of the premium; the size of the growing net working capital, the growing ratio of market and book value have a positive effect on the value of the premium (Walkling, Edmister, 1985).
- *Differences in legislation and legal regulation of minority shareholders' rights.* Regulatory restrictions prevent the controlling shareholder from taking full advantage of his position, thereby narrowing the gap between minority and majority value. Also, developed legislation can prevent violations of statutory rights of shareholders.
- *Increase in the number of buyers participating in the auction.* According to some studies, the presence of competition increases the seller's power and leads to an increase in the price paid for the acquired company. Thus, it is quite expected that sellers can purposefully follow the tactics of increasing the number of buyers participating in the auctions in order to increase final deals (Ryabova, Petrova, 2017).
- *System and procedure of voting.* At the moment, there are two fundamentally different voting systems, the use of which can significantly affect the size of the control premium. The majority voting system is based on the principle "one voting share in a company equals one vote". In most cases, this system allows the owner of a controlling interest to almost completely control the voting results. The opposite situation occurs with cumulative voting. Under this system, the number of votes belonging to each shareholder is multiplied by the number of persons to be elected to the board of directors of a company, and the shareholder has the right to cast the votes thus obtained fully in favour of one candidate or distribute them between two or more candidates (Pratt, 2001). However, despite this, cumulative voting still does not provide guaranteed representation of minority shareholders in the board of directors: not only do minority shareholders need to correctly accumulate their votes, they also need to have enough shares to elect their chosen candidate. For these reasons, cumulative voting can both increase and decrease the control premium.
- *Qualified majority requirements.* For example, in order to make such decisions as a merger of a company with another organization or dissolving of a company, in some companies it is necessary to have a larger shareholding than 50%+1 plus one share. Such provisions are usually established in the articles of association or charter of the organization. Based on this, we can conclude that a shareholding that has a certain control, but not sufficient to carry out certain actions related to the functioning of the company, contains the features of both a minority and majority shareholding. At the same time, if a minority shareholding has the right to prevent some corporate decisions, a certain additional premium is usually added to the value of this stake over the cost of the usual, "non-blocking" minority shareholding.
- *Casting vote potential.* If the share capital is distributed approximately equally between two or more large shareholders, an additional premium may be added to the value of the minority block. A premium arises if the owner of a small shareholding is able to obtain the "casting vote", which can lead to a change in the existing capital allocation (Rodionov, Perevalova, 2011).
- *Other factors* affecting the size of the control premium include the rights of minority shareholders in the board of directors, rules for regulating mergers and acquisitions, the maturity of capital markets, mechanisms for protecting investors, the effect of managerial bad faith, the type of joint stock company, types of owners and their investment motives, the presence of state and preferred stakes shares, type of transaction and

method of payment, the right to appoint directors in accordance with the agreement, as well as such important factors as methods of business (shareholding) valuation and control premium; purpose of the assessment; industry affiliation and others.

## 2. Analysis of premiums and discounts for the presence or absence of control features

When determining premiums and discounts for the presence or absence of control features in the assessment of shareholdings and stakes in the authorized capital of companies, data from the stock market and the market for mergers and acquisitions are used in assessing the value of a business.

Speaking of the most recent empirical studies on the determination of the average value of control premiums, we should mention those like “Mergerstat/BVR Control Premium Study” (Mergerstat Control Premium Study, 2018), an analysis of historical data on premiums and discounts for the control of a team of authors led by S. Pratt (Pratt et al, 2007), as well as studies by J.R. Hitchner (Hitchner, 2003) и K. Simonyan (Simonyan, 2014).

The BVR company is one of the leading organizations in the business valuation industry. It publishes the annual “Mergerstat/BVR Control Premium Study”, which examines the average of premiums and discounts for control, both in USA transactions and in transactions made outside the USA. The report considers only transactions in which more than 50.01% of the company was acquired. The main argument for such a sample is the fact that a controlling interest is more valuable than a minority one, since it gives the buyer the right to influence the further management of the company (Mergerstat/BVR Control Premium Study, 2018).

Thus, in the second quarter of 2018, 127 transactions were analysed in Mergerstat in which the acquired company was public. 65 transactions between US and 62 transactions between non-US public companies were reviewed and the amounts of control premiums were determined. The results of the study are presented below in Table 1.

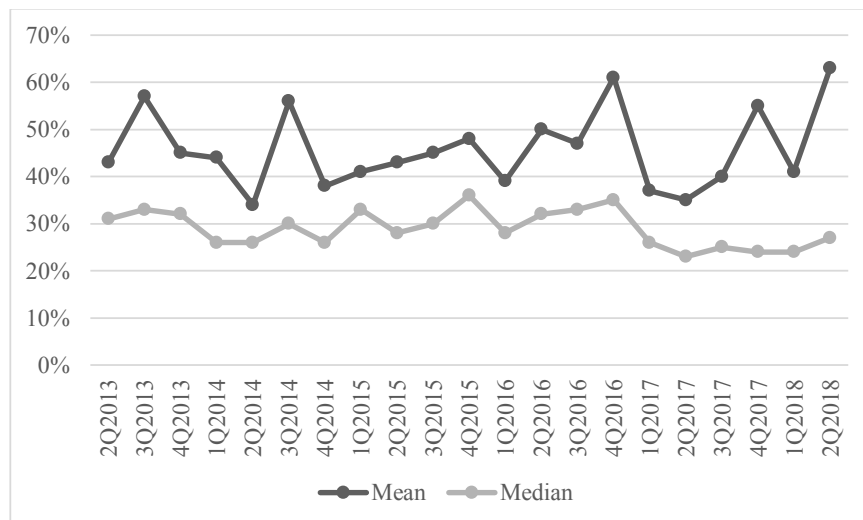
Table 1

Average and median control premiums for 127 M&amp;A transactions of public companies 2nd quarter 2018

	Including Negative Premiums		Excluding Negative Premiums	
	# of Deals	Premium (%)	# of Deals	Premium (%)
Domestic Average	65	52.10%	57	63.30%
Domestic Median	65	25.90%	57	28.50%
International Average	62	36.60%	43	63.20%
International Median	62	16.40%	43	29.10%
Overall Average	127	44.50%	100	63.30%
Overall Median	127	24%	100	28.80%

Source: Mergerstat, Mergerstat Control Premium Study, 2018

Table 1 shows the average and median premiums, however, according to Mergerstat, local US deal premiums for control ranged from 98.8% for Fairmount Santrol Holdings to 662.5% for Excel Corporation. At the same time, premiums (discounts) for international transactions ranged from -92.5% for Itaúsa-Investimentos Itaú SA to 515.9% for Haeduk Powerway. In general, the lowest median and average values of control premiums were observed in the construction and textile industries. The median premiums in these industries were 15% and 8%, while the averages were 16.2% and 13.8%, respectively (Mergerstat, 2018). The value of control premium in a five-year retrospective according to the research of Mergerstat (Mergerstat Control Premium Study, 2018) is changes between 35% - 65% (mean) and 25% - 35% (median).



Source: summarized by the authors based on Mergerstat data

Fig. 1. Dynamics of control premiums in M&A deals from 2013 to 2018

According to the study conducted by K. Simonyan (Simonyan, 2014), from 1985 to 2005, the average and median value of the control premium in M&A transactions in 2005 was 29.85% and 21.3%, respectively. In the authors opinion, when comparing these data with the results of Mergerstat presented above, it can be noted that the average value of the premium for the last 5 years significantly exceeds this value in 2005, while the median indicator fluctuates approximately in the same interval in both time intervals.

It should be noted that in the markets of new European countries and in the Russian market, the possibility of conducting such studies is limited due to the insufficient level of stock market development, imperfect regulatory framework, as well as the limitedness of information and the large influence of subjective factors that determine the pricing of transactions. However, an analysis was conducted in 2007 by E. Evstafieva of the average value of premiums and discounts for control based on the Russian market data using a scheme similar to the method used by Mergerstat (Evstafieva, 2007). The algorithm for this study was as follows:

1. Analysis of major transactions for the sale of shareholdings and mergers and acquisitions in 1998-2005. As a result, 400 transactions were analysed, for which quotations were subsequently searched for.
2. Study of such parameters as the quantitative and qualitative characteristics of the shareholding, the amount of the transaction, the date of the purchase announcement, the seller and the buyer for each transaction.
3. Calculation of the cost of one share in the sold shareholding. This indicator was based on the total amount of the transaction and the number of shares sold.
4. Analysis of market quotes of the company's shares on the stock market. Quotes were determined as an average value three months before the date of the announcement of the transaction (or before the date of the deal if there is no announcement date).

As a result of all actions, the final sample was only 50 trades.

Calculation of the premium for the size of the shareholding. This value was determined using the following formula:

$$P = (C_1 - K_1) / K_1 \quad (1)$$

P - control premium;

C<sub>1</sub> - one share value in the shareholding

K<sub>1</sub> - quotation of one share on stock market

The results obtained during the study are presented in Table 2.

Table 2

Average level of premiums and discounts according to the Russian market for the period 1998-2005

Size of shareholdings in merger and acquisition transactions	Average premium	Average discount
Less than 25%	31%	24%
Less than 50%	30%	23%

Source: summarized by the authors using results of the research by Evstafieva, 2007

The data obtained indicate that the average level of the premium for transactions with shareholdings of less than 25% and with shareholdings of less than 50% differ insignificantly. It can be concluded that the results of this study are quite comparable with foreign statistics. The authors failed to find more recent studies devoted to determining the average level of premiums and discounts in the Russian market.

In this paper, the authors did not set a mission to look into the methods for determining the size of control premiums, which could be the topic of the next article. Usually, a comparative approach is used for this purpose, as well as a cost and income approaches. The importance of the comparative approach in this matter is worth noting, since only its use makes it possible to determine the value of both controlling and minority interest. The methods of cost and income approaches can only reveal the price of the controlling interest, since only the owner of the company can carry out such operations as liquidation of the company, sale of part of its assets, formation and distribution of various cash flows.

### Conclusions and recommendations

According to the purpose and results of the paper, the authors provide several conclusions and recommendations.

The results have shown that the presence or absence of control in a company has a significant impact on the size of the premium or discount for a shareholding both in the investment markets of “old” and in the investment markets of “young” countries. Since the conducted analysis aimed to address the issue of determining the volume of premiums and discounts for control when assessing the value of a business, the results have provided the evidence that a premium for control can significantly increase the value of a business or a shareholding being sold (by 7% - 82%). At the same time, the lack of control leads to the application of discounts when assessing the value of a business, and their size can also vary from 7% to 82%. The most obvious finding to emerge from the paper is that the magnitude of control premiums and discounts is rather significant.

Also, when studying the size of the control premium, it is necessary to know what elements of control the analysed shareholding possesses in order to understand what rights and powers its owner has. Based on the literature review, the authors recommend the owners of companies to solve the task of increasing the value of their own business (both for the purpose of analysing the company's activities and for the purpose of selling it) using a systematic approach. This means that work on increasing business value must be carried out taking into account positive experience in mergers and acquisitions; fluctuations in stock market indices; active implementation of fintech technologies, especially taking into account the experience of banks in emerging market; activities for an increase in the turnover of companies, including those related to consumer behaviour. All this creates the preconditions for effective business management and increasing its value, which has a positive effect on the level of control in the company.

The analysis of research conducted in the field of premiums and discounts for control made it possible to identify the factors that have the greatest influence on their size. Given the magnitude of these premiums and discounts and their significant impact on the final value of transactions, the authors recommend managers and specialists of enterprises in young European countries to work in the direction of improving such indicators that affect control premiums, such as:

- degree of concentration of the evaluated company share capital,
- financial status and financial performance of the company,
- differences in country laws governing shareholder rights and their use,
- presence of competition for the purchase of a particular company,
- presence of a system and procedure for voting established in the company.

This paper has thrown up many questions in need of further investigation. In authors' opinion, further research may be devoted to the study of premiums and discounts for liquidity of enterprises' assets.

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