



Why marketability is so important for the investor

By David J. Mayotte

On a Friday earlier this summer, approximately 1.4 billion shares exchanged hands on the New York Stock Exchange (NYSE). The Nasdaq had approximately 1.7 billion shares exchange hands. These numbers represent the shares traded only on one day. Those numbers seem amazing!

What makes these volume numbers so impressive is that Fridays in the summer typically represent lower volume trading days. Is all this volume good for the stock market?

Today, investors take liquidity for granted. What investors do not realize, however, is that liquidity may be an exception and not an assumed right.

Exception may be too strong of a word but ask the shareholder of a closely held company. The market is not often open on a company that does not have an active market of willing buyers and sellers. Stock of closely held companies may lack marketability or liquidity.

Marketability is defined as the ability to quickly convert property to cash at minimal cost. For marketability to exist, there has to be a significantly large enough pool of willing buyers and willing sellers to create liquidity. For this article, the terms marketability and liquidity can be used interchangeably.

Marketability can vary from active public trading (immediate sale and cash proceeds received in three business days) to little or no trades at all with restrictions on the seller and/or buyer. Many investors prefer

liquidity and dislike the lack of liquidity/marketability that many closely held companies have.

Publicly traded stock is the benchmark for marketability; proceeds on these sales can be received in three business days, there are minimal transaction costs, and the price realized is very close to a known market price. If all three of these items do not exist, there may be a lack of marketability for that particular company's stock.

In business valuations, valuers often apply a lack of marketability discount to compensate for this impairment in market value. There have been numerous studies over the past 35 years or so that have attempted to assess what the marketability discount could be for the stocks of closely held companies.

Two types of transactions

These studies have focused primarily on two types of transactions: restricted stocks issued by companies and pre-initial public offering (pre-IPO) stocks. The results vary widely and cover many different time periods as well as industries (for example, one study dealt exclusively with dot-com companies). Although the results do vary widely, one common theme became apparent throughout all the studies: a company's stock was worth less if it lacked marketability than if it were liquid.

Let's look at an example that illustrates the lack of marketability with a restricted stock. Company A, which is publicly traded, issues restricted stock to a key employee. The restrictions on the stock do not lapse until one year after the issue is granted.

On the day that the restricted stock is granted, Company A's stock is quoted and actively traded at \$10 per share on the NYSE. Since the restricted stock cannot be sold for one year, it lacks marketability (it cannot be converted to cash in three business days).

The fair market value of the restricted stock is worth less than \$10 per share without any other intervening factors. An investor could buy Company A's stock for \$10 in the open market without any restrictions; therefore, it is not likely that an investor would pay \$10 per share for the same exact security that lacks the ability to be sold immediately.

An example of a pre-IPO transaction would be similar to a grant of restricted stock. The stock would be issued prior to the company's initial public offering. For our example, let's assume that Company B sold stock to existing employees at \$8 per share approximately six months prior to a scheduled IPO. Company B eventually goes public six months later at \$10 per share.

It may appear that management gave itself a benefit by selling the stock to themselves and other employees at \$8 and not \$10, which was the ultimate IPO price. But, after additional analysis, this may not be the case. There was a six-month window that the shareholders bore significant risk. General market conditions or Company B's industry could have changed and prevented the IPO from occurring or occurring at a price less than \$10 per share.

Dot-com bust

A perfect example of this would be the dot-com industry and the tech bubble that occurred. Many of those companies canceled their IPOs because of unfavorable conditions. Pre-IPO shares lack marketability and, oftentimes, have restrictions attached on them as well.

Many investors prefer liquidity in the stocks that they own. This gives investors the ability to convert the stock to cash whenever they want or need to. Investors do not bear the risk of being unable to sell during changes in general market conditions or changes in the company's conditions.

Investors may pay more for this marketability; therefore, they may pay less for stocks that lack marketability even if it is the stock of the same company. The difference is called the marketability discount.

It is a complex process to assess the proper marketability discount for

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a particular company's stock. There are many factors to consider that were not discussed in this article that can affect the lack of marketability.

Some of these factors would include the size of the potential market of buyers, the company's prospects for going public or being acquired, what restricted transfer provisions exist (if any) on the company's stock, the dividend history of the company, type of business, past and future performance, the economic arena and if any "put" rights exist where the investor can force the company to buy back

its stock.

Back to the question posed earlier: Is all this volume good for the stock market? While much of the growth in volume may be due to the hedge funds and day traders, increased volume provides an indication of increased liquidity and marketability. I would say, in general, that is good for the market and helps the process.

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