Private Valuations: A Devalued Mirage?

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How to Reduce the Gap Between Public and Private

A few years ago, I was enjoying a short holiday in Victoria, a dreamy Canadian city boasting a quaint harbour and slow pace. It felt like I was in London, England, and I was relaxed and happy.

Then, I noticed a floating home for sale at a price that was less than half of the nearby condos but with similar square footage. This made no sense to me; who would pay double for a condo when they can live right there on the harbour?

My holiday was officially hijacked by the diversion, and I was stoked to profit from this apparent mispricing. I had visions of quiet evenings on the deck of my floating home, parked next to a fleet of floating homes that would become the beginnings of my future real estate empire.

It took a few turbulent days to sort out, but what I had seen was more of a "floating mirage." These harbour homes sell with no associated land and simply depreciate over time thanks to the harsh seawater.

After considering these key differentiators, it became apparent that floating homes are indeed worth roughly half of an equivalent nearby condo. While my spouse was less thankful for the journey, my holiday was memorable—thanks to the lesson in the importance of capturing all relevant factors of a value assessment.

On many occasions since, I have learned other valuation lessons including many painful comparisons between quality private companies and equivalent publicly traded stocks. With a heavy dose of envy, one often concludes that private valuations are 30-50% of a comparable public company. Is the notion of severely devalued non-publicly traded companies simply another agonizing mirage? If so, what relevant factors could explain such a divergence?

Unlike the floating homes, I have concluded that private company shareholders have the opportunity to confront this valuation gap and do better when contemplating the harvest of their lives' work.

Three challenges must be faced to close the public market gap and improve the corporate valuation.

Valuation Gap Challenge 1
Liquidity Discounts

Clearly, selling one's shareholdings on a public exchange is relatively easy. In 2022, the New York Stock Exchange processed an average of 38.3 million daily trades. On the other hand, the selling of private shares necessitates a world of due diligence and transactional complexities that could justify a valuation gap. Determining a "fair" gap is complex and often starts by studying public company shares with restrictions. These restricted stock studies indicate that illiquidity has historically attracted gaps of at least 25%.

A recent study by NYU Stern looked at bid-ask spreads and regressed that gap against firm revenues and cash on hand (among other things). Using this data, one could then estimate that valuation gaps of 20-30% for illiquidity are expected within our financial markets. There is no doubt, liquidity is a formidable challenge.

A **bid-ask spread** is the difference between the asking price of an asset and its bidding price.

Gap Reduction Idea
Control Premiums

A glimmer of hope can rest on the fact that most private share trades are for control of the company, whereas public trades are for minority positions. Control allows the shareholder to adjust cash flows related to reinvestment and/or dividend payments, changing the potential growth rate of the firm. The growth rate is key in the valuation.

Control also allows the shareholder to impact the firm's cost of capital by adjusting the firm's operating or financial leverage. Control premiums can run in the 20-30% range and a private business owner confronted with illiquidity discounts should consider offsetting these using a control premium argument.

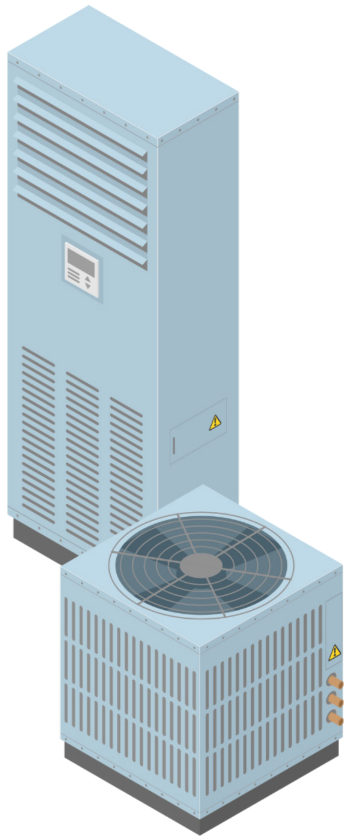
Valuation Gap Challenge 2
The Use of Market Comparables

Many believe that up to 90% of public company trades are based on assessments of share price using comparables, including relative ratios like Price to Earnings (P/E). Private company valuations generally use cash flow analysis to form the valuation opinion but then back it up with a recent transaction comparison. This market-based approach then perpetuates prior valuation gaps between private and public companies.

Gap Reduction Idea
Seek Special Interest Purchasers

A client was looking to sell his HVAC company in 2020 and asked Qube for a valuation opinion. While we had traditionally focused on public company valuations, and we knew that the client's accounting firm would also be providing an opinion, we collected relevant data and proceeded with the assignment. To our great relief, our value assessment put the company at just over $2 million—within a close margin of the value assessed by his accounting firm.

A few months later, the client sold the company for over $4 million. This was another painful learning moment, as a special interest purchaser was looking to consolidate Western Canadian HVAC companies and was willing to pay a premium to close the deal. To them, the market share was priceless. Or, rather, $4 million.



This valuable lesson teaches us that private businesses could gain a significant advantage, should they locate a buyer with post-acquisition synergies. While successfully negotiating these advantages to the vendor's benefit is tricky, the situation can certainly crush the valuation gap. Other post-acquisition synergies could include opening a new market and distribution for cross-selling opportunities, or accessing financing previously unavailable, or even passing regulatory barriers which previously prevented growth.

Valuation Gap Challenge 3
Discount and Hurdle Rates

When valuing public and private companies, future cash flows are discounted based on perceived risk, but the methodology used to determine the rate differs. Public company valuations generally use the Capital Asset Pricing Model (CAPM), focusing the discount rate on a measure of relative share volatility.

Private company valuations generally use a build-up method, arbitrarily stitching risk premiums together, or simply peg a hurdle rate to the company. For example, a valuator may use a 20% discount rate against all small private companies. This clearly creates a scenario where public companies gain the advantage as their future cash flows receive more generous treatment.

The minimum return rate on an investment required to offset costs is typically called a **hurdle rate.**

Gap Reduction Idea
Reduce Risk, Consider an ESOP

A small reduction in the discount rate (e.g., from 20% to 17%) can lead to large valuation changes. Making the argument that aspects of the deal are lower risk can dramatically affect the valuation gap with private companies. Consider, for example, an Employee Share Ownership Plan (ESOP). When employees are engaged as shareholders, operating margins become slightly more protected, brand disruptions reduced, and growth rates more optimistic. These—and related discount rates—all reflect a lower-risk transaction with higher resulting values.

One could leave it at that, but there is so much more. There are many things a private business owner could consider to close the valuation gap against a public company. Here are three additional ideas to close the gap.

Optimal Use of Debt

Private business owners are infamous for underutilizing debt. Debt can be a powerful tool, allowing for higher reinvestments at a lower cost of capital. Pointing out the potential use of debt in a pending transaction should only help the valuation. Strategies to deploy debt into the valuation include adjusting the reinvestment and growth rate projections or simply using the debt to buy back shares (or fund a special dividend).

Tax Shields

Tax shield contemplations are unique to private company valuations. A business that has made poor reinvestment decisions in hard assets can offset the valuation impacts by highlighting the future depreciation adjustments to future profits via the Capital Cost Allowance. This is referred to as a "tax shield" and can certainly bump up the valuation of a private business. Never mind the opportunity to structure the transaction in a manner to maximize tax shields (asset versus shares sales), which brings in a host of unique tax planning available to private transactions.

Normalization Assumptions

Finally, private valuations often host a round of cash flow "normalizations" that impact value. The classic normalization is business expenses that would not happen should that shareholder no longer be present. But owner-manager remuneration adjustments are just the beginning of normalizations, which could include transfer pricing adjustments when related corporations are involved, market value adjustments on non-arm's length situations like owner-occupied space, and unjustified or redundant investment in non-core operations. Making an investment and a successful case on such normalizations earns a solid return on the valuation impact.

In Conclusion...

Public and private companies are cousins, not siblings. There are enough differences between them and their related valuations to justify large valuation gaps. At the same time, there are many strategies worth considering and implementing which exist to confront the lower valuations given to private companies.

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