ASSET VALUATION BULLETIN

2022

EDITOR MESSAGE

Welcome to the Asset Valuation Bulletin issued by RHL Appraisal Limited. In this knowledge-based economy, a successful corporate management and investor need to be versatile to capture business opportunities, whilst understanding in accounting and finance is imperative to deal with the dynamic market. In response we launch this bulletin with the aim to share with you a wide range of useful knowledge and information, including but not limited to insight on current rules, and regulations, technical knowledge, market news and practical experience relating to asset valuation. We hope this bulletin could become one of your preferred knowledge update platforms.

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Group Introduction

RHL International is one of the pioneering professional valuation and real estate consultants in Asia. Established since 1972, our group offers high quality professional services on Corporate Valuation & Advisory and Real Estate Solution & Surveying Practice. As an active participant in exchanging ideas and experience with regulators, government institutions and corporations, our group maintains vigilant to the dynamic changes in the market. Leveraging our extensive track record, technical resources and market intelligence, we are dedicated to provide tailored services to meet with the unique needs of our clients.

Scope Of Services

Our experience in operating businesses in the mainland China and cooperating with overseas parties has become our competitive advantage in offering comprehensive client solution to overseas as well as mainland clients.

- Industry Market Research & Analysis
- Project Feasibility Study and Advisory
- Financial Analysis
- Investment Advisory
- Due Diligence
- Valuation (including Real Estate, Business Valuation, Plant & Machinery)
- Corporate & Valuation Advisory
- Real Estate Solutions and Surveying Practice

VALUATION CONCEPTS YOU NEED TO KNOW!

Application on Discount for Lack of Marketability (DLOM)

Readers who have seen a business or equity valuation report may be aware of the term "Discount for Lack of Marketability" which is quite an eye catching item. This is because to many who are not familiar with this essential valuation concept, it can be surprising, frustrating and if not heartbreaking to see anything from a staggering 20% to 50% discount off on the subject company valued by your business appraiser.

So what is it? Why the big discount? How come in some cases there are no DLOM?

What's the deal with Discount for Lack of Marketability (DLOM) – An official definition with explanation

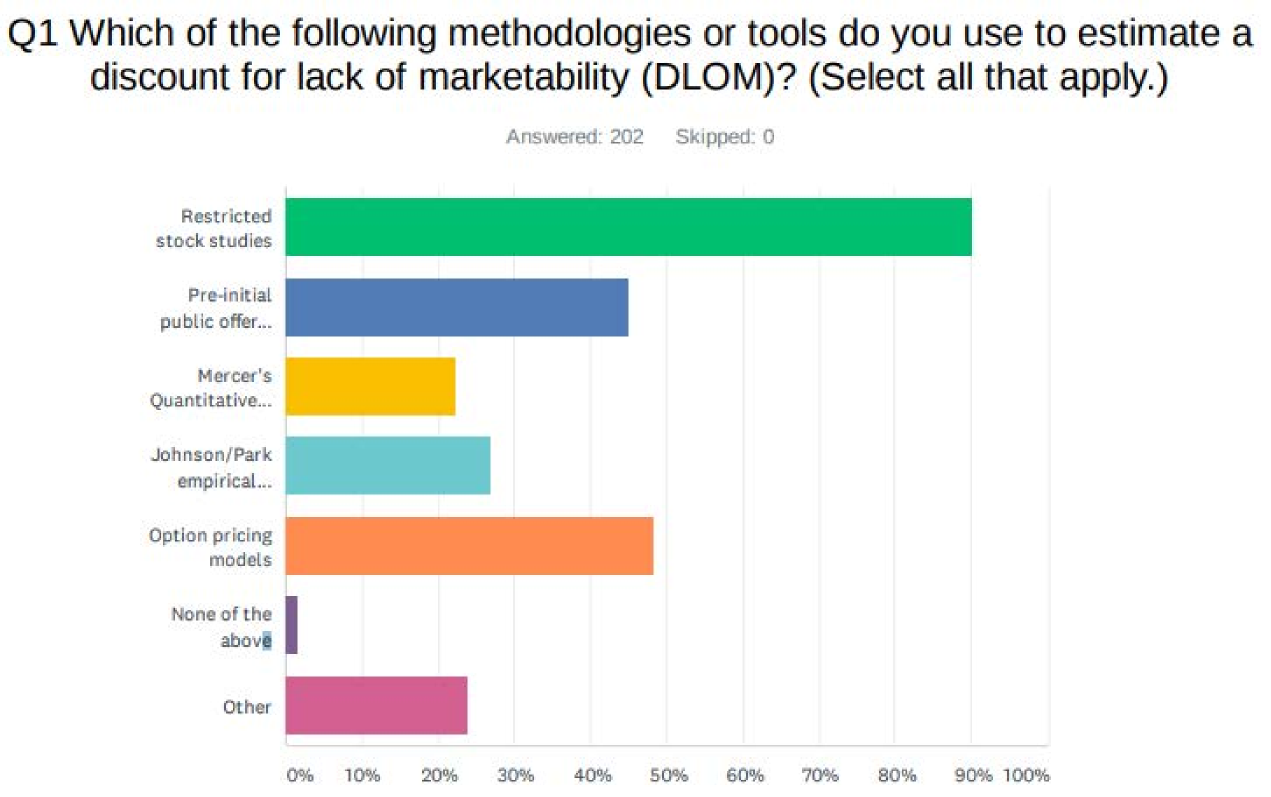
According to the International Valuation Standards ("IVS"), "*a DLOM reflects the concept that when comparing otherwise identical assets, a readily marketable asset would have a higher value than an asset with a long marketing period of restrictions on the ability to sell the assets.*"

Hence the DLOM reflects additional time and effort to sell the shares of a company that is not freely traded on a stock exchange with adequate liquidity. For example, selling shares of a listed company on the Hong Kong Stock Exchange can be as easy as a few clicks on the mobile phone, with minimal time and transaction costs. On the other hand selling the shares of one's own private company to an outsider who have no knowledge of its business shall encounter many difficulties, which including but not limit to the lack of potential buyer aware of the private company is on sale and their confidence on the authenticity of legal, financial and operational information provided by the owner. All of these factors contributes to a discount on the company valued.

What are the common methods to determine a Discount for Lack of Marketability (DLOM)?

According to the survey results by Business Valuation Resources, LLC[1] in July 2021, the top 3 methodologies used by practitioners to estimate a DLOM are:

1. Restricted stock studies
2. Option pricing models
3. Pre-IPO studies



Scope of Business:
Financial Instrument Valuation & Sensitivity Analysis

Due to the increasing role of financial instruments and their significant impact on the value of a corporation, mark-to-market valuation of complex financial instruments is required to match current accounting standards.

Leveraging a team of experts adept at applying sophisticated financial models, our group provides solutions for equity or debt-related instruments and derivatives.

[1] BVResources, "Discount For Lack Of Marketability (DLOM) , Accessed on 28 Jun,2021

Referenced to "Valuation premiums and discounts" [2] by Eugene Liu and Noah Wong presented in HKICPA Aplus in April 2017, Pre-IPO studies are more suitable for the target equity interest is going to be listed. When applying to company that has no time table for listing, the Pre-IPO studies may incorporate a failure probability for the listing and take account of high costs involved during the IPO process.

Depending on the information available and the practical situation of each cases, the abovementioned methodologies can results in as low as a few percent up to 90% discount on the company valued, with a more common application of around 20%-50% of DLOM.

The situation where Discount for Lack of Marketability (DLOM) is not applied

DLOM can be commonly seen in valuation for accounting and transaction reference cases. However there are situation which calls for a different perspective thus under specific or agree upon assumption, acknowledgement and consent of the user of the valuation can overlook DLOM. For example a private company is valued using expected exit value, in which marketability may already be considered or a private company is valued with reference to its recent capital raised, marketability may have been built in the implied value. When the underlying equity interest of a company is already freely tradable in a liquid market, DLOM may be inapplicable or immaterial.

[2] Eugene Liu & Noah Wong, "Valuation premiums and discounts" https://app1.hkicpa.org.hk/APLUS/2017/04/pdf/44_Large_Source.pdf Accessed on April 2017

Scope of Business:
Scenario Analysis & Calculation of Value

We can help executives better understand any future financial impact while also enabling them to fulfill risk management disclosures in compliance with accounting standards or acquisition negotiations. We provide scenario analysis services that calculate the value of financial instruments or the business to be invested. Our professional analysis can give you the insight you need to determine the terms of financial instruments with counter parties or terms of negotiation for a business.

Controversy with Discounts for Lack of Marketability (DLOM)

Billion Lead Investment v. Union Joyce Ltd and others [HCMP 2145/2011]

Here the decision handed down by the High Court on 13 August 2015 in the matter of *Billion Lead Investment v. Union Joyce Ltd and others* [HCMP 2145/2011], which focus on the discount for lack of marketability (DLOM) in valuation analysis.

Background

The valuer was jointly appointed by the parties and the valuation exercise on a private company, Talent Weaving Dyeing & Printing Limited (the "**Company**"), was carried out pursuant to the terms of settlement between the parties to a Tomlin Order made on 18 March 2014. The valuer performed its valuation analysis on market value basis in accordance with International Valuation Standards ("**IVS**").

On 19 December 2014, the valuer circulated a draft valuation report to the parties, in which the market value of 100% equity in the Company was based on the market approach without accounting for DLOM. On 23 January 2015, the respondents submitted their written representations to the valuer asking for substantial adjustments to the valuations set out in the draft report that a discount of 25-30% on the multiples would fairly reflect the difference between the Company and the comparable companies. On 6 February 2015, the valuer said it was of the opinion that the valuation in the draft valuation report reasonably reflected the fair value of the Company and planned to issue its final report the next week.

On 9 February 2015, the respondents issued the Summons to ask the court to give further valuation decision to the valuer and asked the valuer to withhold issuing the final report. On 4 May 2015, the valuer issued its final report with the same valuation as in the draft valuation report to the parties before the court has yet to provide instructions.

High Court Decision

On 13 August 2015, the High Court handed the decision that the court is not minded to disturb the valuation made by the valuer. The judge viewed "*the valuer has not departed from its instruction to apply the IVS in evaluating the market value of the shares. These IVS only set out the different approaches to valuation in general terms and leave the application of these approaches to the discretion and judgment of the valuer in any individual case. The fact that a valuer may make adjustments in accordance with the IVS implies that, in the exercise of his judgment, he may not. It cannot be said that the valuer is acting within his instructions to follow the IVS if he makes adjustments, but he is acting outside them if he does not.*"

Observation

This is an interesting case in the sense that the outcome was in favor of ***no*** DLOM to 100% equity interest of a private company.

As previously mentioned, it is a common practice when the subject company is a private company while the comparable companies are listing companies with far larger operating scale than the subject company, adjustments for the differences between the subject company and publicly-traded securities should be made.

The valuer in this case opined that "a 100% equity interest in an unlisted company is generally considered to be marketable, it is a common valuation practice not to apply the discount for lack of marketability in the valuation of a 100% equity interest of a private company. Given that we were engaged to value 100% of the equity interest in [the Company], we considered it appropriate not to apply any discount for lack of marketability in our valuation analysis. On first sight this treatment is not common in most valuation works for accounting and transaction purposes, which apply DLOM to account for difference between private companies and listing companies used as market comparable. This observation is made after going through the public circulars and announcement of transactions with extract, summary of or in whole the valuation reports that are disclosed in the public, with the application of DLOM being the common practice under a fair value accounting perspective. One can only envisage that the valuation done in the above case was under an engagement with specify definition and assumptions which are not disclosed, such as already assuming that a potential buyer that must complete that transaction exist. This highlight the importance of the basis of valuation and the premises for using the valuation.

It is also worth noting that according to the findings in other jurisdiction and regions, such as "*The Existence of, and Earnings Quality Explanations for, the Private Company Discount, by Gus De Franco Illait Gavious, Justing Tin, and Gordon D. Richardson*", marketability discounts for the acquisition of private companies were between 21% and 37%. This study in 2006 compared private acquisitions of 100% ownership interests in privately held U.S. companies to acquisitions in public companies. The sample consisted of 673 private companies and 2,249 public companies.

Things to remember in applying Discount for Lack of Marketability (DLOM):

1. DLOM is appropriate when the subject interest is non-marketable, yet the prior steps in the valuation process result in a marketable value.
2. DLOM is not appropriate if the prior valuation process has already taken marketability concerns into consideration.
3. DLOM is applied after minority interest discount or control premium where such is appropriate to a valuation problem.
4. DLOM should be determined on its own factors and not combined with other discounts

Source: Discount for Lack of Marketability, Job Aid for IRS Valuation Professionals, 25 September 2009

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