

Noncontrolling interests in business combinations

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June 2020

Introduction

A noncontrolling interest (NCI) is identified in an acquisition when the buyer acquires a controlling financial interest in a target, but owns less than 100%, of the target's voting equity interests (for example, when a buyer purchases more than 50%, but less than 100% of the target, or when a reporting entity initially becomes the primary beneficiary of a variable interest entity). Under Topic 805, "Business Combinations," of the Financial Accounting Standards Board's (FASB) Accounting Standards Codification (ASC), the NCI must be recognized and measured at its fair value when accounting for the business combination. Because the NCI generally represents less than 50% of the target, its fair value may be subject to downward adjustments from its pro-rata share of 100% of the target's fair value. These downward adjustments or discounts may be necessary to reflect both the lack of control and the lack of marketability of the NCI. Additional complications in determining fair value exist when the NCI is not comprised of the same share class or classes as the controlling interest.

This whitepaper is organized in the following sections: (a) discount factors table and (b) examples.

Determining the fair value of an NCI can be difficult as determining whether discounts are necessary, and quantifying discounts, if applicable, requires many complex considerations and involves significant judgment. Multiple indicators and circumstances need to be considered and evaluated in the determination of the potential existence of a discount for lack of control (DLOC) and a discount for lack of marketability (DLOM). The DLOC and the DLOM need to be assessed separately and independently as determining the fair value of an NCI may require both discounts, only one discount or neither discount.

This white paper specifically relates to NCIs in business combinations. The discount factors table and examples reference circumstances unique to business combinations and NCIs. However, this guidance can also be considered in the following situations:

- Fair value of rollover equity
- Fair value of equity consideration

- All other fair value requirements related to the determination of the fair value of a minority interest (e.g., stock compensation)

Additional discussion for the first two situations is provided in the remainder of this section.

Rollover equity

Rollover equity is often used in private equity (PE) backed transactions where a group of existing shareholders, typically consisting of founders and (or) key management, reinvest a portion of their transaction proceeds into the company they just sold. The reinvestment usually takes place in a newly-formed entity or holding company. There are several important characteristics of rollover equity:

- PE investors look to rollover equity to reduce their cash outlay, in effect financing a portion of the transaction with the selling shareholders' reinvestment.
- PE investors look to align the interests of management with their investment thesis.
- Selling shareholders receive liquidity and continue to participate in the future upside of the business alongside the PE investors.
- PE investors and selling shareholders negotiate the terms of the transaction, including purchase consideration attributed to cash and rollover equity, on an arms-length basis suggesting an outcome agreed upon by market participants.

Based on this typical fact pattern, which generally aligns the interests of the PE investors with the rollover shareholders (i.e., the rollover shareholders will only accept rollover shares with value equivalent to what they would have otherwise received in cash), it is frequently inappropriate to apply discounts to determine the fair value of rollover equity consideration. However, this typical fact pattern does not mean a buyer may forgo consideration of its specific facts and circumstances surrounding the fair value of rollover equity in a particular transaction. The buyer should consider and document the factors that led to a reasonable conclusion about discounts in its specific facts and circumstances.

Multiple share classes

One common exception to the treatment of rollover equity occurs when the selling shareholders roll into a class of stock that is different than the class of stock of the controlling PE investor. In this circumstance, the buyer should first consider value differences attributable to the company's complex capital structure, and then consider whether discounts are applicable to the rollover equity class of stock. This approach and the factors to consider in calculating value and applying discounts is discussed in the upcoming discount factors table.

Equity consideration

Equity consideration exists when the buyer issues its own stock to the selling shareholders of the target. The fair value of equity consideration must be determined as of the acquisition date. If the fair value is not readily determinable by reference to the price in an active market (i.e., via a publicly-traded share price), the buyer must calculate the fair value. The calculation of the fair value should consider typical valuation methodologies applicable to the subject interest, including consideration of applicable discounts.

Discount factors table

There is no set guidance as to the inclusion of discounts for NCIs. However, ASC 805-20-30-8 includes the following requiring consideration of potential discounts:

The fair values of the acquirer's interest in the acquiree and the noncontrolling interest on a per-share basis might differ. The main difference is likely to be the inclusion of a control premium in the per-share fair value of the acquirer's interest in the acquiree or, conversely, the inclusion of a discount for lack of control (also referred to as a noncontrolling interest discount) in the per-share fair value of the

noncontrolling, interest if market participants would take into account such a premium or discount when pricing the noncontrolling interest.

The fair values of the acquirer’s interest in the acquiree and the noncontrolling interest on a per-share basis might differ. The main difference is likely to be the inclusion of a control premium in the per-share fair value of the acquirer’s interest in the acquiree or, conversely, the inclusion of a discount for lack of control (also referred to as a noncontrolling interest discount) in the per-share fair value of the noncontrolling interest if market participants would take into account such a premium or discount when pricing the noncontrolling interest. To properly evaluate the cash flow, risk and marketability of a noncontrolling position, both quantitative and qualitative analyses must be performed to determine the unique characteristics of the equity interest being valued. Certain factors should be assessed to determine whether the interests of all investors in a transaction are aligned and any discounts are applicable or appropriate. Following is a table showing common factors that should be considered when valuing a noncontrolling interest. All factors should be considered in reaching a discount conclusion and no one factor is necessarily more significant or conclusive than the other factors.

Factor	Financial buyer DLOM	Strategic buyer DLOM	Financial buyer DLOC	Strategic buyer DLOC
Discretionary cash flows	Generally not applicable, because the controlling interest’s operating plans may suggest a shorter or longer holding period (e.g., a financial buyer that plans to implement operational improvements may have to hold its investment for a longer period to fully implement the changes).		Generally not applicable, except for management fees (see separate entry later in this table), because a financial buyer is expected to manage the target’s cash flows to an efficient level, thus minimizing discretionary cash flows.	Potentially increase DLOC, because the controlling buyer may push down corporate expenses through the cash flows of the target, negotiate contracts, reward past vendors, etc., all of which would increase the DLOC if these operational changes do not maximize returns to the target.
Management fees	Not applicable.		Potentially increase DLOC, such as when if management fees are above market, because the fees are considered discretionary, and the NCI is not able to benefit.	Not applicable.
Discretionary and nonoperating assets	Not applicable.		Generally not applicable, because a financial buyer is expected to manage the target’s cash flows to an efficient level, thus minimizing discretionary assets and nonoperating assets.	Increase DLOC if discussions indicate discretionary assets or nonoperating assets exist.

Factor	Financial buyer DLOM	Strategic buyer DLOM	Financial buyer DLOC	Strategic buyer DLOC
Drag-along rights	Decrease DLOM, because the NCI has the obligation to sell with the controlling interest, which creates marketability.		Increase DLOC, because controlling shareholders have the ability to control disproportionate to ownership as a result of the NCI lacking control over the price and time at which a sale may occur; however, if the NCI has discretion to sell their shares prior to being compelled to do so in connection with drag-along rights, the increase in DLOC is reduced.	
Tag-along rights	Decrease DLOM, because the NCI has the right to sell with the controlling interest, which creates marketability.		Decrease DLOC, because the rights provide the NCI control over when and (to an extent) at what price they can sell their interests, and because controlling shareholders have a restricted ability to sell common stock as a result of such rights.	
Holding period (HP)	<p>Longer HP = Increase DLOM. Shorter HP = Decrease DLOM.</p> <p>Consider whether there are different principal markets for the controlling interest and the NCI:</p> <ul style="list-style-type: none"> • Same principal market = no DLOM or decreased DLOM. • Different principal market = increased DLOM (consider time required for a secondary market sale of the NCI when determining the extent of the increase). 	<p>Longer HP = Increase DLOM. Shorter HP = Decrease DLOM.</p> <p>Consider the strategic buyer's plans for the target. A strategic buyer generally plans for an indefinite HP, while the NCI likely plans for a shorter HP ending with a sale in a secondary market.</p>	<p>Longer HP = Increase DLOC. Shorter HP = Decrease DLOC.</p> <p>With a shorter HP, the controlling shareholder may not have the necessary time required to introduce controlling benefits and receive those benefits of control.</p>	

In addition to the common factors and deal characteristics captured in the preceding table that should be considered in determining the applicability of discounts attributable to an NCI, certain other facts and circumstances can impact the fair value of the NCI being valued. These other facts and circumstances and related considerations are discussed in the following table.

Active market	Active market exists: When there is an active market price for the shares held by the NCI, the fair value of the NCI equals that active market price
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	<p>multiplied by the number of shares held by the NCI. No adjustments should be made to this amount.</p> <p>No active market: When there is not an active market price for the shares held by the NCI, the starting point for determining the fair value of the NCI is typically the price paid for the controlling interest on an undiscounted basis.</p>
Third-party buyer	<p>If a third party invests in a minority interest alongside the controlling buyer, the price paid by the third party may be indicative of the fair value of the NCI. This would only be the case when all of the following are true:</p> <ul style="list-style-type: none"> • The third party is unrelated to the controlling buyer and the target. • The third-party investment is in the same class of stock as the NCI. • The third-party investment represents a meaningful ownership interest in the target (e.g., the amount paid by the third party is not insignificant to the third party or the total transaction). • The transaction with the third party was orderly, including being exposed to the market for a period of time before it occurred.
Synergies	<p>If the controlling investor paid for entity-specific synergies, there is a difference between the purchase price and the fair value of the NCI before even considering a DLOC and a DLOM. This difference must be quantified before consideration of discounts, and entity-specific synergies should be excluded from the fair value of the NCI.</p> <p>For market-participant synergies derived by strategic buyers, consider whether the synergies are passed to the target or realized by another entity within the same ownership group as the buyer (e.g., the buyer or its parent has multiple subsidiaries that would benefit from the market-participant synergies). The NCI may not benefit from market-participant synergies if those synergies are not passed to the target to maximize returns at the target. Market participant synergies that will not be passed to the target should be considered when determining the fair value of the NCI.</p>
Share class differences	<p>There is a difference between the fair value of the controlling interest and the fair value of the NCI before even considering a DLOC and a DLOM when the NCI is in a junior (or different) class of stock relative to the controlling interest. This difference must be quantified before consideration of discounts.</p>
Step acquisition	<p>Consider whether the buyer obtained control by purchasing a minority interest that combined with its previously held equity interest gives the buyer control. In this circumstance the price paid for the minority interest likely reflects the value of control. Accordingly, the price paid cannot be used to value the NCI unless the facts and circumstances indicate that the fair value of the controlling interest and the fair value of the NCI are equivalently valued.</p>
Other valuations	<p>Consideration must be given to other valuations performed at the time of the transaction and whether discounts are consistently considered within the valuations performed. For example, if an ASC 718, <i>Compensation—Stock Compensation</i>, analysis is being performed for stock compensation accounting purposes, the discounts applied in the ASC 718 valuation should be consistent with the discounts applied in the NCI valuation for purposes of recognizing the NCI in accordance with ASC 805.</p>

Examples

The following premise applies to all examples:

ABC Equity Partners (ABC) purchases a 90% common equity interest in XYZ Technology, Inc. (XYZ). The remaining 10% will be retained by the previous owner of XYZ.

Financial buyer: NCI transaction with *no* DLOC or DLOM

The following information has been gathered:

- ABC is a financial buyer with plans to hold XYZ for three to seven years.
- XYZ's previous owner is an employee of XYZ and plans to hold its remaining 10% interest in XYZ until it exits with ABC.
- There is one class of stock.
- ABC will not be paid management fees.
- XYZ's previous owner has tag-along rights, and ABC has drag-along rights.
- XYZ's previous owner has a two-year contract to remain employed by ABC after the transaction.

Based on this information, a DLOC and a DLOM are likely not appropriate:

- **DLOC:** There likely is not a DLOC as the financial buyer will manage the company efficiently to maximize its returns. Because ABC and the NCI hold the same class of interests, it is assumed that anything ABC does to maximize returns will also maximize returns to the NCI. Additionally, there is no above-market management fee which would lead to a DLOC.
- **DLOM:** There likely is not a DLOM as the NCI plans to hold and sell with ABC. Therefore, any marketability factors incorporated in the purchase price are equivalent for the NCI.

Further, per the American Institute of Certified Public Accountants' (AICPA) Accounting and Valuation Guide, *Valuation of Privately-Held-Company Equity Securities Issued as Compensation* (AICPA cheap stock guide), "...when both investors and management hold the same interests, there is no explicit difference in economic rights. Hence, any difference in the value between the investor and management interest would be due to differences in the principal market."

Financial buyer: NCI transaction with a DLOM and *no* DLOC

The following information has been gathered:

- ABC is a financial buyer with plans to hold XYZ for seven years.
- XYZ's previous owner is an employee of XYZ and plans to sell its remaining 10% interest in XYZ at the end of his contractual employment term (see last bullet point).
- There is one class of stock.
- ABC will not be paid management fees.
- XYZ's previous owner does not have tag-along rights, and ABC does not have drag-along rights.
- ABC has the right to match any offer received by any potential buyer of XYZ's previous owner's NCI.
- XYZ's previous owner has a two-year contract to remain employed by ABC after the transaction.

Based on this information, a DLOC is likely not appropriate. However, a DLOM is likely appropriate:

- **DLOC:** There likely is not a DLOC as the financial buyer will manage the company efficiently to maximize its returns. Because ABC and the NCI hold the same class of interests, it is assumed that

anything ABC does to maximize returns will also maximize returns to the NCI. Additionally, there is no above-market management fee which would lead to a DLOC.

- **DLOM:** There likely is a DLOM as the NCI plans to sell prior to exit by ABC, and there is a restriction on sale (right to match). In addition, there are no drag-along or tag-along rights.

Strategic buyer: NCI transaction with a DLOM and *no* DLOC

The following information has been gathered:

- ABC is a strategic buyer with no plans to exit its investment in XYZ for the foreseeable future; however, XYZ's previous owner may wish to exit early, leading to different principal markets.
- There is one class of stock.
- ABC has no plans to merge and scale XYZ with its operations, but rather intends to manage XYZ's cash flows on an efficient, standalone basis.
- XYZ's previous owner does not have tag-along rights, and ABC does not have drag-along rights.
- ABC has the right to match any offer received by any potential buyer of XYZ's previous owner's NCI.
- The transaction had a limited pool of buyers due to the niche focus of XYZ.
- XYZ's previous owner has been granted one of ten board seats based on its pro-rata ownership interest.

Based on this information, a DLOC is likely not appropriate. However, a DLOM is likely appropriate.

- **DLOC:** There likely is not a DLOC as the strategic buyer will manage the company efficiently to maximize its returns. Because ABC and the NCI hold the same class of interests, it is assumed that anything ABC does to maximize returns will also maximize returns to the NCI. The NCI also holds some rights of control through its board seat.
- **DLOM:** There likely is a DLOM as the NCI and ABC have different principal markets and holding periods if the NCI looks to sell its interest. Further, the pool of potential buyers is limited. There is also a restriction on sale (right to match), and there are no drag-along or tag-along rights.

Strategic buyer: NCI transaction with a DLOC and a DLOM

The following information has been gathered:

- ABC is a strategic buyer with no plans to exit its investment in XYZ for the foreseeable future; however, XYZ's previous owner may wish to exit early, leading to different principal markets.
- ABC plans to merge operations with XYZ to take advantage of operational synergies.
- There are two classes of stock: (a) Class A Voting and (b) Class B Nonvoting. ABC owns all of the Class A stock and the stock retained by XYZ's previous owner is Class B.
- XYZ's previous owner does not have tag-along rights and ABC does not have drag-along rights.
- Class B stock does not have the right to a board seat.

Based on this information, a DLOC and a DLOM are likely appropriate:

- **DLOC:** There likely is a DLOC as the NCI has limited influence, and no board seats. Also, the NCI class is specifically nonvoting.
- **DLOM:** There likely is a DLOM as the NCI and ABC have different principal markets and holding periods if the NCI looks to sell its interest. There is also a restriction on sale (right to match), and there are no drag along or tag along rights.

Further, a valuation difference likely exists prior to consideration of discounts because the controlling interest and the NCI are held in different classes of stock.

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