



A PEEK THROUGH HEDGES PROVIDES INSIGHT ON VALUATION DISCOUNTS

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A common hedging strategy for equity investors in volatile markets is the purchase of put options (“puts”), to protect investments against market declines. A “put” provides the holder with the option (but not an obligation), to sell a stock at a pre-determined price (strike price), at any point in the future until the expiration date of the option contract. Put options may be purchased by bearish investors who bet that the price of a particular stock will decline in the future. These bearish investors make money on “puts” when the stock price drops below the strike price. At that point, the investor is able to purchase the stock on the market at the depressed stock price, while exercising the option right to sell the shares at the pre-determined, higher strike price. Thus, if the put option strike price is \$25, and the stock price drops to \$15, the investor would exercise the option, effectively purchasing the stock at \$15 (current market price), and concurrently sell it for \$25 (strike price), gaining \$10 (minus the cost of the option), in the process.

“Puts” are also purchased by investors as a means to hedge (insure) against losses in stocks they already own. For example, if you held shares of General Electric (GE), with a current market price of \$19.70 per share, you might consider purchasing long-term put options (LEAPs), with a strike price of \$20.00 (to coincide with an anticipated holding period). Since the put option enables you to sell the shares for \$20.00 at a point in the future (before the expiration date of the option), you effectively purchase insurance against price declines over the term (through expiration date) of the options. The cost of these put options, say \$3.45 per option, represents the cost/price of the protection/insurance. In this case, the insurance cost represents 17.5% of the value of the stock ($\$3.45/\19.70).

The risk of market value decline during a time period, over which one is unable to sell an asset, forms the basis for discounts for lack of liquidity and/or lack of marketability associated with the asset. There is ample evidence in markets that assets that are not readily salable (restricted stocks, for example), trade at discounts relative to their freely traded counterparts (unrestricted, publicly traded stocks). If the risk of a decline in value over the holding period is removed, the associated discount would be mitigated. Thus it is argued that the cost of a put option, where the strike price is set at the current market price of the underlying asset (referred to as an “at the money” option), stated as a percentage of the value of the underlying asset, provides a reasonable proxy for the minimum level of discount for lack of liquidity/marketability associated with the asset.



Taking the GE example above, and assuming that one was unable to sell a share of stock for the 21 month period coinciding with the option term, a relevant minimum benchmark for the discount associated with the restricted stock, relative to the freely traded shares, might be 17.5%.

While stock and option prices related to publicly traded securities are relatively easy to determine by reference to market quotations, this information is obviously not readily available regarding the privately held businesses that are often the subject of business valuation. However, similar to the comparable company market methods that are sometimes employed in business valuation, one may also reference stock and option quotations for similar companies, or companies that operate in the same industry as the subject company, for purposes of guiding appropriate levels of discounts. Alternatively, option pricing formulas, which incorporate certain assumptions such as price volatility, can be employed to estimate option values for privately held enterprises.

Thus, option pricing can be used to provide the valuation expert with additional guidance and valuable insight as to appropriate levels of discounting, perhaps removing some of the subjectivity of this exercise. Some strengths of this approach include the ability to incorporate industry specific characteristics and trends, such as volatility, current market and economic conditions (as of the valuation date), dividends/distributions, and other unique/specific factors. On the flip side, it may be argued that this methodology produces a “minimum discount” as it may not capture the entirety of the discount associated with a lack of liquidity/marketability over the holding period. In other words, while the put option value reflects the cost of insurance against price declines over a holding period, it may not account for conversion costs, opportunity costs, etc. Additionally, this methodology may become less reliable as anticipated holding periods extend beyond two or three years. As a result, this discount estimation method, as with most valuation approaches, is best used in conjunction with other methods.

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