Control Premiums: Minimizing the Cost of Your Next Acquisition

BY MICHAEL DAVIS, PH.D.

EXECUTIVE SUMMARY: It has long been acknowledged that a controlling interest in another business entity embodies valuable rights not available to a noncontrolling interest. Payment for these rights, known as a control premium, is a well-established concept in the mergers and acquisitions arena, but many bidders overpay for these rights. This article is designed to provide the information needed to avoid a similar fate.

Your company is thinking about acquiring another company. The timing seems right, and you have identified several possible candidates. The main concern at this point is setting the right price and not overpaying for the acquisition. While you are fairly aware of the various methodologies utilized in setting a price—discounted cash flow analysis, number of times revenue, appraisal valuation, and the like—you are cognizant that they yield only approximations, and you are anxious about paying too much. Your uneasiness, in fact, may be well founded because there is an element of acquisition pricing that is often misunderstood. Yet, armed with a comprehensive understanding of this concept, your company can lower the total cost of its next acquisition.

THE CONCEPT OF CONTROL

Two well-known academics, Michael Jensen and Richard Ruback, define corporate control as: the rights to determine the management of corporate resources.1 Because these rights are not available to a noncontrolling interest, part of the purchase price paid to acquire another company most likely includes a payment for obtaining control—termed a control premium. Included are the rights to:

1. Appoint management;
2. Determine management compensation and perquisites;
3. Set policy and change the course of business;
4. Acquire or liquidate assets;
5. Select people with whom to do business and award contracts;
6. Make acquisitions;
7. Liquidate, dissolve, sell out, or recapitalize the company;
8. Sell or acquire treasury shares;
9. Register the company’s stock for a public offering;
10. Declare and pay dividends;
11. Change the articles of incorporation or bylaws; and
12. Block any of the above actions.²

In the simplest case, control conveys the right to declare the payment of a cash dividend. Of potentially far greater importance, the controlling interest has the right to hire and fire top management. This, in turn, can significantly influence the profit-making potential of the controlled entity, with a resultant impact on the controlling interest’s share. For example, top management has the ability to acquire or liquidate assets, including acquiring or divesting entire companies.

Note, however, that most of the benefits are irrespective of desirable assets that the acquired entity may possess, such as patents, exclusive locations, or cutting-edge technology and personnel. Moreover, these benefits are distinct and separate from synergies, which are revenue enhancements or cost savings due to beneficial relationships between related entities. Synergies typically result when related entities are in similar lines of business because one entity is selling to and/or buying from the other entity. Examples would include additional sales volume due to the buyer’s or seller’s existing distribution channels, savings from consolidation of manufacturing facilities, elimination of duplicate sales forces, and reduction of general and administrative expenses.

Taken to the extreme, an acquisition could involve no synergies (i.e., it is in an unrelated line of business) and few, if any, desirable assets and yet still yield many of the control benefits listed above. For example, an acquisition that allows the controlling entity to get a quicker toehold in a market or to enter one in which entry is restricted (e.g., a radio station) may include sufficient control perquisites to justify paying a premium simply to achieve control of the entity. That is why understanding this element of an acquisition—and how to value it—is crucial to determining the right price to pay.

Valuing a Business
There are numerous approaches to valuing business entities as a whole, including stock price and volume history, comparable company analysis, comparable transactions analysis, discounted cash flow analysis, capitalization of earnings, and breakup analysis. Although these methods are widely used, many suffer one major shortcoming: They do not specifically value—or even consider—the cost of obtaining control. Moreover, even those that do incorporate this cost typically neglect some key issues, one of which is absolutely critical to valuing control premiums correctly: On how many shares should a control premium be paid? Once calculated, most methods—and, consequently, the bidders that use them—incorrectly assume the control premium applies to all shares being acquired.

To give you the tools to master control premium theory, I offer a brief discussion of two well-known valuation methods followed by a presentation of a well-established approach from the business appraisal literature that specifically incorporates control premiums in company valuations. Practical applications of the theory, as well as some cautions, should aid you in implementation.

Discounted Cash Flow Analysis
The discounted cash flow analysis (DCF) method estimates the value of a business by forecasting net future cash flows that the business is expected to generate and discounting those flows back to the present using a discount rate—termed the required rate of return by some—that incorporates the time value of money and the risk associated with the flows. If the acquisition is to be synergistic, an estimation of the amount and timing of those benefits also would be included in the analysis. The result—or present value—establishes a maximum amount to be paid. If the cost of the acquisition is less than this amount, the actual return to the buyer will exceed the required rate of return; if the buyer ends up paying more, the required rate will not be met.

This analysis, however, calculates a value for the entire company. Even if converted to a per-share amount, there is no distinction made between the value of control versus noncontrolling shares, how to measure that value, or on how many shares it should be paid. This is because the primary focus in DCF is valuing the future benefits of owning a company, not the intricacies of zeroing in on a price that will induce sufficient numbers of holders to sell today.
COMPARABLE COMPANY ANALYSIS

The comparable company analysis method involves evaluating the target company against comparable public companies, including vital financial and operating statistics for the target and comparables. A premium per share necessary to entice holders to sell enough shares for the acquiring company to obtain a controlling interest would be added to this figure. While this methodol-

Figure 1: Relationships between Control Premiums, Synergies, Minority Interest Discounts, and Discounts for Lack of Marketability

A combined 20% discount and a 45% discount for lack of marketability equals a total of 56% discount from value of control shares.b

Notes:

a Control shares in a privately held company may also be subject to some discount for lack of marketability, but usually not nearly as much as minority shares.
b Minority and marketability discounts normally are multiplicative rather than additive. That is, they are taken in sequence:

\[
\begin{align*}
\$10.00 & \quad \text{Control Value} \\
- \$2.00 & \quad \text{Less: Minority interest discount (}.20 \times \$10.00) \\
\$8.00 & \quad \text{Marketable minority value} \\
- \$3.60 & \quad \text{Less lack of Marketability discount (}.45 \times \$8.00) \\
\$4.40 & \quad \text{Per share value of non-marketable minority shares}
\end{align*}
\]

ogy sounds reasonable, identical or even close comparables may not exist. Moreover, accounting policies can vary significantly among companies, rendering comparison problematic. Finally, although annual averages on premiums paid above existing share price are readily available, they are simply broad historical averages, providing minimal guidance on the likely premium for company A to acquire company B today. For example, in 2002, premiums ranged from zero to a nearly unbelievable 1,525% for Venture Catalyst, Inc., a firm providing consulting services to start-up and emerging growth companies.

Moreover, reported statistics for 2000-2002 indicate that some acquisitions were made at a discount from the current share price, up to 97% below share price for a firm with large continuing losses. Obviously, average or median premiums become pretty meaningless with these kinds of variations. Complicating the analysis even further, reported premiums often contain payment for synergies and other valuable aspects of a target company besides control and so are better termed acquisition premiums, not control premiums.

In summary, the popular DCF method gives little guidance in valuing control premiums, and comparable company analysis has difficulty in separating it from other elements of target company valuation. The next approach is one that deals with these shortcomings.

**Fishman and Pratt Approach**

Jay Fishman and Shannon Pratt present a well-established framework in their book, *Valuing a Business*. The Fishman and Pratt approach (F&P), illustrated in Figure 1, centers on an estimate of “fair market value” per share on a free-standing, going-concern basis ($10 per share in Figure 1). Absent any synergies, this price is equivalent to the value of controlling shares. This value is normally higher than the current share price, which is viewed as the value of minority noncontrolling shares, or the current “stock market value.” The difference between these two amounts represents the value of having control. On top of the control valuation is another layer of value, representing synergies that may flow to particular buyers.

Several aspects of this approach are noteworthy. First, the “stock market value” of $8 per share in Figure 1 automatically includes the market’s estimation of hard-to-value intangible assets, including goodwill attributed to the entity on a freestanding basis. Second, the F&P approach correctly separates amounts paid to acquire control from amounts paid for expected synergies. Third, the methodology also applies to valuing non-publicly traded companies as the “discount for lack of marketability” represents the discount applied to minority or noncontrolling shares in appraisals of privately held companies. Finally, and most important, the F&P approach relies on valuation of the firm by the stock market. Given the vast body of empirical evidence supporting efficient markets, this methodology avoids the inherent subjectivity of the estimation process in many of the other methods. Although the F&P model neglects the issue of how many shares a control premium needs to be paid, it provides a supportable framework and starting point to begin the analysis.

**Keys to Implementation**

Maximizing the benefits from using the F&P methodology to minimize the cost of your next acquisition hinges on capitalizing on two critical, but rarely acknowledged, phenomena of the mergers and acquisitions marketplace:

- **Effective control of an entity can occur at levels substantially below a majority ownership (50.1%) interest—even below 40%.** This situation can happen when there is one large minority voting interest and no other party or organized group of parties has a significant interest. For example, if only 60% of the eligible votes typically are cast in elections of directors, a minority holding of 35% can be large enough to provide control. Alternatively, a significant minority shareholder, say someone who owns 30%-40% of the shares, could become the controlling shareholder without incurring any control premium if a 55% controlling owner subsequently sold its interest. If those shares become widely dispersed, the 30%-40% shareholder ends up with effective control even without purchasing any of the former majority owner’s shares. As a real-world—though extreme—example, Reuters reported that on March 27, 2000, DaimlerChrysler purchased a 34% “controlling” stake in Mitsubishi Motors at a price of 20 yen lower than the
closing price of 470 yen that day, making no payment for control.4

◆ Once control of another entity is obtained, increased ownership does not lead to increased control or increased benefits of control.5 Using the most simplistic case, if 50.1% guarantees control, there would seem to be no reason for a bidder to pay a control premium for shares in excess of 50.1%. In other words, measurement of the control premium should be based on the shares needed to obtain control, not on all of the shares purchased in the control transaction when more than a controlling interest is acquired.

This latter issue addresses the all-important question of the number of shares for which a control premium needs to be paid. One could even question the economic justification of paying a control premium for shares in excess of those necessary to obtain control. Emphasizing the disastrous consequences of this possibility, David Henry states several times in a cover story article in Business Week that “bidders paid too much” because, in their eagerness to snare a deal, the premium paid “gobbled up the merger’s whole potential economic gain from the get-go.”6

Using This Knowledge To Your Advantage

There is little doubt about the potential value of having control of another entity. The key is knowing when and how much to pay for it. Let’s look at a succinct strategy for the shrewd bidder to minimize the total cost of an acquisition.

Overall considerations:

◆ Remember that average premiums are just that—averages of large samples that contain wide variations in actual premiums. As mentioned previously, the highest premium in 2002 was a whopping 1,525%, whereas the average for the 326 acquisitions that year was only 60%. As evidence of the skewed nature of these results, the median—or middle value—of the 326 acquisitions was only 34%. Averages and medians, if relatively stable over time, however, can provide a critical “first estimate” as to the reasonableness of a proposed premium in a specific acquisition. Table 1 summarizes premium statistics compiled by Mergerstat for 1993-2002, the latest information available.7

While a premium is paid in most acquisitions, there are situations where a premium is not justified. Instead, in some cases, a discount to current share price may be in order. The company is in bankruptcy, management is ill-qualified to run the company, the company’s products are out of date, the company is privately held, and the owners have special estate planning considerations, etc. As an extreme example, the November 13, 1996, issue of The Wall Street Journal reported that Ronald Perelman, controlling shareholder (80%) of Marvel Entertainment Group Inc., announced he was planning to buy 80% of Marvel’s new stock issuance at a steep discount from the current market price ($0.85 per share vs. $4.62 prior to the announcement). Although Marvel had been ailing for a year, Jill Krutick of Smith Barney put the discount in perspective: “People thought he’d buy in at a discount, but no one expected it would be this dramatic.” For specific guidelines, Mergerstat reports discounts (“negative premiums”) for 2000-2002 for the five largest discounts each year, which range from 59% to 98%.

◆ If the target is privately held, the actual amount per share to be paid as a control premium depends largely on the desirability of the firm and the negotiating skills of your team, since you will be dealing directly with the board of directors. With a public company, additional considerations include the normal volatility of the share price and the likelihood of additional bidders emerging. In both cases, the goal is to minimize

<table>
<thead>
<tr>
<th>Year</th>
<th>Average Premium</th>
<th>Median Premium</th>
<th>Highest Premium</th>
<th>Number of Transactions</th>
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<tr>
<td>1993</td>
<td>38.7%</td>
<td>33.0%</td>
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<td>1994</td>
<td>41.9%</td>
<td>35.0%</td>
<td>169%</td>
<td>260</td>
</tr>
<tr>
<td>1995</td>
<td>44.7%</td>
<td>29.2%</td>
<td>195%</td>
<td>324</td>
</tr>
<tr>
<td>1996</td>
<td>36.6%</td>
<td>27.3%</td>
<td>604%</td>
<td>381</td>
</tr>
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<td>1997</td>
<td>35.7%</td>
<td>27.5%</td>
<td>99%</td>
<td>487</td>
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<tr>
<td>1998</td>
<td>40.7%</td>
<td>30.1%</td>
<td>100%</td>
<td>512</td>
</tr>
<tr>
<td>1999</td>
<td>43.3%</td>
<td>34.6%</td>
<td>99%</td>
<td>723</td>
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<tr>
<td>2000</td>
<td>49.2%</td>
<td>41.1%</td>
<td>376%</td>
<td>574</td>
</tr>
<tr>
<td>2001</td>
<td>57.2%</td>
<td>40.5%</td>
<td>900%</td>
<td>439</td>
</tr>
<tr>
<td>2002</td>
<td>59.7%</td>
<td>34.4%</td>
<td>1,525%</td>
<td>326</td>
</tr>
</tbody>
</table>

the total amount paid for the shares so if a smaller number of shares are involved, a larger premium per share could be justified to seal the deal. In any case, negotiate to pay the premium on as few shares as possible. The most extreme situation, although highly unlikely, is to pay it on only one share—the share that gives you absolute control. Obviously the less desirable the firm (out of favor, near bankruptcy, declining markets, etc.), the lower the need for any payment for control and the greater the possibility of negotiating a discount.

◆ Taken together, the mere fact of control does not automatically lead to any specific premium; in fact, it does not necessarily lead to any premium at all. A premium to obtain a controlling interest is justified only if the acquiring firm believes it can enhance the value of the target company, with the amount of the premium dependent on the specific incremental value potential. Obviously, different buyers will view both the extent and value of the identified potentials differently so that a competitor’s higher bid may, in fact, be justifiable for them but not for you. If you have performed a thorough value analysis and the price gets significantly beyond your well-reasoned maximum bid, walk away and look for another target that matches your strategic and financial goals. Do not let the excitement of “doing the deal” cloud your judgment and cause you to pay too much and give away the very benefits you were hoping to obtain.

For a publicly traded target company:

◆ With the F&P model, use the current share price as a starting point. Due to inherent fluctuations in the daily price, a 30-day average may provide a more stable number.

◆ Consider acting on the fact that effective control can occur at ownership levels substantially less than 50.1%—even below 40%.

• Determine how widely the shares are dispersed, as the more widely dispersed the shares, the smaller the block of shares needed to carry the day because the number of shares voted at shareholder meetings also will be lower.

• Little or no control premium needs to be paid if absolute control is not obtained. This significantly decreases the total cost of the controlling interest.

• A downside of this approach is that, under current accounting rules, less than 50.1% ownership will mean that the entity cannot be consolidated but will instead be accounted for using the equity method. This will not change consolidated income, as the equity method still includes the investor’s share, but the investee’s specific assets, liabilities, revenues, and expenses are not shown, so any potential benefits due to a larger asset or sales base—such as increased borrowing power—will not be realized.

◆ If absolute control is desired, a control premium should be paid only on those shares necessary to obtain control, not on all shares acquired.

• Acquire as many shares as possible by making a “creeping” acquisition of numerous smaller purchases of 5%-15%. When ownership is near the 50.1% threshold, make even smaller purchases. Once control is achieved, larger block purchases of the remaining minority interest can be pursued if 100% ownership is desired. This goal can be achieved without the need to pay a control premium because control already has been obtained. And, yes, there are some SEC requirements to follow here—namely, disclosing your intentions once you own 5%. But it can be done by making well spaced-out purchases, resulting in significant savings.

• If the target firm has a small number of float shares (see “Some Cautions” below), it may be necessary to negotiate directly with its board. The advantage of this approach is that your team can explain the elements of your bid very carefully, using the information presented here. Instead of just offering $X per share, you can negotiate the price depending on whether control is to be obtained. If not, a control premium should not be part of the offer price. If more than 50.1% is desired, serious consideration should be given to planning a two-stage acquisition: 50.1% now, paying a control premium, and the remainder at some future date. If this is your real intent, this approach can save significant amounts compared to the “once and done” acquisition where all shares are acquired in a single transaction—and a needless control premium is likely paid on every share above the 50.1% threshold.
For a privately held target company:

◆ As all negotiations will be with the target firm’s board, the acquisition team will be in a position to explain the reasoning behind their offer, justifying why a control premium should not be paid on every share. As there is substantial confusion over “acquisition” premium vs. “control” premium in the marketplace (see “Some Cautions” below), careful and reasoned analysis will help in convincing the target firm’s management and their advisers that your offer price is reasonable and equitable. If accepted, your firm will have avoided overpaying for the target firm and the dire consequences that may result. It will also give you the confidence to “walk away” if the target firm’s demands become too outrageous.

Some Cautions

The market can be a fickle creature, and no model captures its movements completely. In structuring a bid for another company, be aware of the following confounding influences—factors that can throw you off track.

First, stock price gyrations of public companies during merger negotiations can be so large that the ultimate acquisition price may bear little resemblance to the initial bid. As a case in point, in the glory days of United Airlines, there was a takeover fight between Marvin Davis and UAL management during 1989-90. Davis’s opening bid on August 8, 1989, was $5.4 billion—$240 per share and $75.50 above the pre-bid price of $164.50. On September 1, 1989, the pilot’s union and UAL management offered $300 per share, for a total of $6.75 billion. Following the “mini” market crash on October 13, 1989, UAL stock dropped from $285 to $223. The union-management offer was reduced to $225 to $240 per share ($5.1 billion to $5.4 billion) on October 23, 1989. This offer subsequently fell to an estimated $185 per share ($4.1 billion) on March 20, 1990. Negotiations were terminated soon after. Although the acquisition was never completed, note that the premium over the pre-bid price varied from a high of $135.50 per share—or 82%—to a low of only $20.50 per share—or 12%.

Second, some companies have only a small percentage of their shares traded, termed float shares. As a result, any significant change in trading volume—due to a host of potential nonacquisition-related influences such as industry announcements, strike threats, interest rate fluctuations, economic outlook reports, etc.—can significantly impact the stock price, rendering valuation of a control premium based on float share price suspect.

Third, there have been periods when average premiums paid for a minority interest position exceeded the average premium paid to acquire controlling interests. Third, there have been periods when average premiums paid for a minority interest position exceeded the average premium paid to acquire controlling interests.

Table 2: Average Percent Premium Paid for a Controlling vs. Minority Interest, 1986–2002

<table>
<thead>
<tr>
<th>Year</th>
<th>Controlling Interest (%)</th>
<th>Number of Transactions</th>
<th>Minority Interest (%)</th>
<th>Number of Transactions</th>
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<tbody>
<tr>
<td>1986</td>
<td>39.1</td>
<td>308</td>
<td>27.2</td>
<td>25</td>
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<td>1987</td>
<td>38.2</td>
<td>228</td>
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<td>1988</td>
<td>41.9</td>
<td>402</td>
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<td>8</td>
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<td>1989</td>
<td>41.8</td>
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<td>59.8</td>
<td>315</td>
<td>39.9</td>
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Source: Mergerstat Review, Mergerstat, New York, 1994 and 2003. Amounts in bold are years in which the average premium paid in acquiring a minority interest exceeded the average premium paid to acquire controlling interests.

Fourth, Patrick Gaughan, in Mergers, Acquisitions, and Corporate Restructurings, states:

The normal ups and downs of the stock market cause
stock prices to rise and fall more than can be explained by variations in their earnings or dividends. This causes some stock to be overpriced at times and underpriced at other times.  

Whether the unexplained movements reflect true under- or over-pricing, or are simply due to unidentified variables, Gaughan’s statement questions the usefulness of share price as a reliable reference point.

Finally, the marketplace often labels premiums incorrectly in mergers and acquisitions. Premiums calculated and termed control premiums often include payment for synergies and valuable assets. This practice, unfortunately, muddies the water in getting a good handle on how much was actually paid to obtain control. For example:

◆ Investment bankers often measure a control premium as the simple difference between the bid price per share and the prevailing pre-bid stock price. This is actually the total premium, including potential synergies.

◆ In Mergerstat’s annual Control Premium Study, control premiums are defined as the “additional consideration that an investor would pay over a marketable minority equity value (i.e., The Wall Street Journal price).” This sum, again, includes amounts paid for potential synergies.

◆ JP Morgan uses the same definition but complicates the issue further by using different terms to mean the same thing. According to a February 5, 1996, internal memo discussing a report on median takeover premiums paid during 1988-1995, the terms “control premia,” “takeover premia,” and “acquisition premia” all refer to the median excess paid over the pre-bid price.

**Lower the Risk—and the Cost**

No one likes to needlessly overpay for a purchase, no matter what it is. With acquisitions, the consequences can be costly and long lasting. Armed with a reasonable understanding of the issues involved, however, tremendous strides can be made by the shrewd bidder in lowering this risk—and therefore the cost. When your company is thinking about doing another acquisition, use the concepts presented here to evaluate carefully how you should attempt to gain control and what price you should be willing to pay.

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**Footnotes**


4 The 34% interest represented an “effective” takeover because under Japanese law, DaimlerChrysler would have the power to veto board decisions.

5 There are, however, benefits to increased ownership beyond a simple majority in some situations. Some states have enacted statutes requiring supermajority votes on major actions such as mergers or sale of the company. There also can be benefits to filing consolidated tax returns, which requires at least 80% ownership. For example, the target firm may possess net operating loss carryforwards or unused investment tax credits that can offset the bidder’s taxable income.


