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How to Use the Latest DLOM Study for the Johnson/Park Empirical Method

Over a quarter (27%) of valuation practitioners surveyed say they use the Johnson/Park Empirical Method for determining discounts for lack of marketability (DLOM) in the valuation of interests in privately held entities.[1] The recently released "2022 Discount for Lack of Marketability (DLOM) Study" provides current DLOM rates of return to use when implementing the method.[2]

In a nutshell. The method is based on the fundamental financial concept of risk and reward, i.e., when risk increases, an investor will demand a higher return. But just how much higher? The Johnson/Park Empirical Method provides a basis to determine how much of an increase in the rate of return is required to compensate investors for the lack of marketability of a subject interest. The method involves making an analytical adjustment (applying a DLOM) to increase the rate of return of the investment to compensate for the additional risks an investor is exposed to when holding a nonmarketable interest. The application of the DLOM results in an increase in the effective rate of return of the investment.

Three research studies are used (published annually): "Private Equity vs. Public Equity Returns," "Restricted Stock Transactions," and "LT vs. ST Bond Horizon Risk." This methodology was introduced in 1995 and has been used in several tax court cases including the first family limited partnership (FLP) case to go to trial.

2022 rates. The three annual studies the 2022 report examines show that investors continue to demand 30% to 45% higher rates of return for the additional risk of holding a nonmarketable investment or being exposed to increased risk over the holding period. Comparing the 2022 findings with the research that has been conducted since 2006 indicates a similar range of results for the average increase in the required rate of return (see Exhibit 1).

By applying a DLOM to a noncontrolling, marketable value, the average return on a privately held interest can effectively be increased to a reasonable level to compensate an investor for the lack of marketability and the additional risks

1 "BVR Survey on Methods Used for Estimating a Discount for Lack of Marketability (DLOM)"—July 2021; free download available at:

2 Available at bvresources.com/products/2022-discount-for-lack-of-marketability-study.

Exhibit 1. Increase in Rates of Return Required to Hold a Nonmarketable Investment

Studies	2018	2019	2020	2021	2022	AVG
Private Equity vs. Public Equity Returns	36.4%	37.6%	35.7%	43.6%	44.8%	39.6%
Restricted Stock Transactions	29.5%	29.5%	29.5%	29.5%	29.5%	29.5%
LT vs. ST Bond Horizon Risk	43.5%	42.2%	46.5%	51.6%	43.1%	45.4%

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associated with the ownership of the privately held interest.

Example. Assume the subject interest is an interest in a limited partnership that owns an established apartment complex. The value of a 1% limited partnership interest is $80,000 on a noncontrolling, marketable basis, and the cash flow to the 1% interest is $9,000 per year. Dividing the annual cash flow by the noncontrolling, marketable value results in a rate of return (as measured by yield) of 11.25% (see Exhibit 2).

The research in the 2022 study indicates that an increase in the rate of return of 30% to 45% would be reasonable to compensate for the additional

Exhibit 2. Application of DLOM to Increase Rate of Return

Annual cash-flow forecast	$ 9,000
Divided by noncontrolling, marketable value	80,000
Yield on a noncontrolling, marketable basis	11.25%
Value of a 1% noncontrolling, marketable interest	$80,000
Discount for lack of marketability 25%	(20,000)
Value of a 1% noncontrolling, nonmarketable interest	$60,000
Annual cash-flow forecast	$ 9,000
Divided by noncontrolling, nonmarketable value	60,000
Yield on a noncontrolling, nonmarketable basis	15.0%

Exhibit 3. Increase to Rate of Return After DLOM

	Rate of Return
Before discount for lack of marketability	11.25%
After discount for lack of marketability	15.00%
	3.75%
Incremental increase	33.33%

Reprinted with permissions from Business Valuation Resources, LLC risks due to the lack of marketability. The second calculation in Exhibit 2 shows that applying a DLOM of 25% increases the rate of return and lowers the value to $60,000 for a 1% noncontrolling, nonmarketable interest. The final calculation in Exhibit 2 shows the rate of return after the application of the DLOM, which results in a rate of return (yield) of 15%.

In this example, discounting the noncontrolling, marketable value by 25% effectively increases the projected annual return of a noncontrolling interest by 33.3%, from a rate of 11.25% to a rate of 15% (Exhibit 3).

Final point. Just where a subject interest falls within the 30%-to-45% range will depend on the facts and circumstances of the valuation. The 2022 study describes those factors, which include volatility of the underlying interests, historical results, size attributes, growth outlook, and more. ◆

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