# HearSay

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## *Meet Clark County's Newest Rule K-9 Intern*

# September Hearsay Contributor

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# A Legacy Worth More than $12 million

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**Introduction**

In every business valuation engagement, it is essential to define the standard of value. As it is often said, "beauty is in the eye of the beholder," so it is true that the value of a business depends on one's perspective and what definition is being applied.

In most cases, business appraisers are asked to determine fair market value, which is defined by the American Society of Appraisers as follows:

"The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts."

Even though fair market value most commonly used in business valuation engagement, it is not the only definition of value. In some instances, strategic value[1] which is the value "to a particular buyer" is needed. In a bankruptcy matter, it may be that there needs to be a determination of "liquidation value." In a shareholder dispute, the definition of value may be "fair value" which is defined by state statute and in a marital dissolution matter, the definition of value will depend on the particular jurisdiction.

The purpose of this article is to educate attorneys on the importance of understanding the difference between fair market value and strategic value.

**Case Study**

A business owner, who we will call Raymond Porter, is an energetic gentleman in his 70s who owns Porter Materials, Inc. The company manufactures and sells building materials including doors, windows, molding, hardware, and custom stair systems. It also provides in-house milling services, pre-finish work, and project planning assistance. Porter Materials is located south of Seattle and its customers are primarily residential builders.

Mr. Porter was working with his estate planning attorney who recommended that he obtain an appraisal of his business. He contacted our office, and we decided on a date to meet at his facility, which would provide an opportunity to further gather information, view the premises and understand how the business operates.

At the meeting, Mr. Porter gave a full tour of his manufacturing operation, which included three large warehouses on a 12-acre lot, outfitted with state-of-the-art equipment.

Porter Materials had over 160 employees. In the main office there were plaques on the wall showing the tenure of many key employees, some of whom had been there for over 20, 30 and even 40 years. Four of Mr. Porter's sons worked in the business, with his eldest filling the role of Chief Financial Officer.

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[1]Source: American Society of Appraisers, ASA Business Valuation Standards.

We met in the main conference room where Mr. Porter told me the history of his business. He founded the company with a business partner in 1971, at 21 years old. In the early 1980s, he bought out his partner and remained the sole owner up to the present.

Porter Materials was located on real estate which was not held inside the company, but rather in a separate family-owned limited liability company. Over the several years prior to our meeting, Mr. Porter had achieved many of his estate planning objectives by gifting minority interests in the real estate holding company to his sons.

In order to complete his estate plan, he needed to know the value of Porter Materials. After deciding to hire our firm, we agreed on a timeline, cost and the scope of the project. Specifically, we agreed that he needed to know the fair market value of his business.

A few weeks later, I completed the analysis and sent off a draft report that reflected a fair market value conclusion of $7.5 million.

Upon receipt of the draft, Mr. Porter called to convey his disappointment in the report and the conclusion of value. I apologized for not meeting his expectations and began to explain my rationale when he interrupted me to say, "I think this business is worth $10 million."

By the end of our discussion, Mr. Porter's tone turned more positive, as he realized that the valuation was beneficial because he now understood how his business would be valued upon his death for his estate. We then discussed specific steps that he could take to increase cash flow, and thereby the value of the business.

A period of time went by, perhaps a year, before Mr. Porter reached out again, asking to meet in person to share exciting news.

He had been approached by a buyer, who offered him $11 million for Porter Materials. He grinned and said, "see, I told you it was worth more than $7.5 million." He explained to me that the buyer was based in Philadelphia, a company that served similar customers but was looking to expand and in order to do that, would need a foothold on the West Coast.

He described how he had been courted by the buyers which included being flown to Las Vegas in a Learjet (even showing me the pictures). He was blown away by the whole experience, excited to complete the sale and achieve his financial goals. Everything was moving along, documents had been signed, and they had agreed to a closing date. In addition, he would be required to sign a two-year employment agreement.

Only two months away from closing, the buyers approached Mr. Porter with one last change to the terms, something they thought was insignificant. The initial purchase agreement allowed for all of his staff to stay on for three years. However, the buyers now wanted to change this term to six months following closing.

Mr. Porter pushed back, explaining to the buyers that his staff had worked for his company for decades.

You are asking me to stay on for two years, but six months into the sale, my loyal employees will lose their jobs? I will have to sit in my office and watch them escorted out the door without a thing I can do about it?

He refused to agree to these terms.

The buyers countered with an additional $1 million on the selling price. Mr. Porter refused to budge and the deal fell apart.

**Conclusion**

This story exemplifies the difference between fair market value and strategic value.

When the word "value" is used, many assume that the definition is obvious, however, it is not that simple.[2] The standard of value holds a specific purpose in each business valuation. To achieve the objectives for a particular client, it is crucial to distinguish the various concepts of value that can be used in the appraisal of a company. These concepts are dependent on many factors and can vary drastically depending on the perspective of the parties involved.

Financial buyers will search a variety of industries for companies with significant growth opportunities that are likely to generate large financial returns within a five-to-seven-year period.[3] These investors will typically pay fair market value for the investment and, once their objectives are achieved, the next step is usually to sell the company. A seller that is looking to cash out from the sale of their business, while remaining involved in the operations for a period of time, would ideally sell to a financial buyer.

In contrast, a strategic buyer will seek opportunities to purchase companies that will allow improvement to its existing business operations, by adding new products and services, removing redundant employees, or capitalizing on opportunities specific to their operations. As a result of the synergies the buyer expects to generate from a transaction, strategic buyers are typically willing to pay a premium over fair market value.

The buyers in this situation were looking to make a strategic purchase and willing to add $1 million to the initial offer to ensure that the purchase would go through.

In the end, Mr. Porter recognized his life's work and values were more important than money. He chose his legacy over the $12 million offer. He promoted his eldest son to Chief Executive Officer, ensuring his business would be passed onto the next generation and also retain its employees.

The answer to what a business is worth is complex. The value of a business in an estate planning context might be quite different than the value of the same business in a marital dissolution or in a sale. Attorneys should engage a business appraiser who has the expertise to not only provide a well-supported opinion of value, but is also able to advise the parties on the appropriate definition to apply in a particular legal matter.

Do you have a client who is need of business valuation expertise? Please contact us at 360-601-0713, or at info@Markeevaluations.com.

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[2] A Reviewer's Handbook to Business Valuation, Written by L. Paul Hood, Jr. and Timothy R. Lee

[3] Strategic vs Financial Buyer, Corporate Finance Institute, https://corporatefinanceinstitute.com/resources/knowledge/deals/strategic-buyer-vs-financial-buyer/