Business Owners Choose a Transfer Value

by Robert T. Slee, CBA

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Executive Summary

- Depending on their transfer motives, private business owners actually choose the range of values within which their business will transfer.
- A wide variety of transfer motives leads to a correspondingly large range of possible values for a business. Transfer motives range from needing a change in lifestyle to using the transfer as a wealth-creating vehicle.
- Business transfer alternatives are numerous and comprise a spectrum of channels, or macro options and methods, or specific techniques used to affect a transfer. For example, an ESOP (method) may be used to transfer part of a business within the employee channel.
- A private business value is relative to the reason for the appraisal; that is, every private company has a large number of correct values at a given time, depending on the reason or purpose of the appraisal. Purposes of an appraisal can be described as value worlds. Each value world employs a specific process by which to derive value.
- The choice of transfer method selects a value world, which leads to a specific value.
- Understanding the linkage between transfer motives and business values empowers planners to help clients develop and execute their financial plans.

Financial planners often consult with private business owners regarding various business transfer issues. By "business transfer," we mean the transfer—possibly via gift or other estate-planning technique, or outright sale, of part or all of the business. Because the business typically represents the bulk of a private owner's net worth, a proper transfer is a critical element of the financial plan. What may not be obvious is the role an owner's transfer *motive* plays in setting the value of the business. Surprisingly, answering the question, "What am I trying to accomplish with a business transfer?" determines how much an owner ultimately receives for the company.

Depending on their transfer motives, business owners actually choose the range of values within which their businesses will transfer. For example, owners motivated to transfer the business to employees via an Employee Stock Ownership Plan receive a *fair market valuation*, or value determined through application of the hypothetical "willing buyer and seller rule"; those motivated to transfer via a management buyout are more likely to receive an *investment valuation*, or value that is specific to a particular investor. As is described more fully below, an owner's motive for transferring part or all of the business selects the process by which the business interest is valued. Accordingly, a wide variety of transfer motives leads to a correspondingly large range of possible values for a business.

Linking an owner's motive to a business value requires several steps. First, we will examine the motives for transferring a business. Second, we will consider a structure for the spectrum of private transfer alternatives. Third, we will show that private business valuation is relative to the reason for the appraisal—that is, every private company has a large number of correct values at a given time, depending on the reason an appraisal is needed. Finally, we will connect these thoughts and demonstrate that the choice of transfer method yields a business interest's likely value. This discussion assumes that the business is large enough to access a number of transfer alternatives. Many personal service companies, such as a one-person marketing or medical practice, may not have many transfer options. On the other hand, a midsized advertising or medical firm may possess numerous transfer alternatives. Thus, financial planners should first assess if the client business has the characteristics necessary to qualify for a variety of transfers.

This decision requires substantial experience and may necessitate conversations with other planners, business brokers or investment bankers. The remainder of this article presumes the business qualifies for the palette of transfer choices.

Several private transfer motives are listed in Table 1.

Some private owners need a change of lifestyle; that is, they may *sell out* simply because they are *burned out*. Owners tend to wear multiple hats, which may hasten their timeline to exit the business. Many owners effect a transfer while they are still young, so they have time to seek a new challenge. One survey of business sales indicates that the average age of sellers in the United States is about 56.[1] According to this survey, barring health considerations, retirement was seldom the primary motivation for the sale.

Alternatively, because the business often represents a substantial part of their estate, owners may pursue a diversification strategy. This approach may lead owners to employ sophisticated estate-planning techniques or seek an outright sale for cash.

Another motivating cause for a transfer includes the goal of creating a family legacy. Immortality is well served via blood offspring or spawning a business that continues well after the demise of the founder. Even if no children are present or interested in running the business, many owners feel a loyalty to their employees. For this reason, it is fairly typical for an owner to structure a deal with long-time employees that enables them to own and operate the business.

Finally, some owners view a transfer as their last chance to grab the brass ring. The lure of a major capital event may cause them to forgo some current compensation in order to reinvest in the business to maximize a transfer. Owners with a maximizing orientation may sell-out to a consolidator or competitor, because these buyers can usually pay more than non-synergistic acquirers.

Owners often feel a tension between personal and economic motives. For example, many owners want to transfer the business to their children, yet only about one-third of all businesses survive to the second generation and less than 15 percent to the third generation.[2] This is an obvious example of the conflict between personal and business motives. These contrasting motives drive the choice of transfer method, forcing owners to strike a balance between their hearts and their wallets. This situation also affords planners an excellent opportunity to help clarify an owner's motives, as well as make the owner aware that motives have downstream value repercussions.

Ultimately, a transfer motive leads an owner to action, even though most owners think they have relatively few transfer choices. Some transfer professionals further reinforce this perceived limitation, because they only work in a narrow, specialized area and do not know the full range of available options. As a result, the owner may be advised that selling the entire business is the best solution, when in fact, it may be a less desirable alternative. Far from being limited, there is a wide spectrum of transfer alternatives.

Business Transfer Spectrum

Business transfer alternatives are numerous, but can be illustrated as shown in Figure 1. The macro private transfer options, called *transfer channels*, lead to a cluster of specific alternatives, called *transfer methods*. Transfer methods are the actual techniques used to transfer a business interest. Collectively, transfer channels and transfer methods provide a construct for explaining the range of options available. Owners select transfer channels with the optimum potential, based on their motives for selling.

Transfer methods may be tax driven, market driven, finance driven or a combination of all three. It is frequently possible to combine methods without violating the internal integrity of each, because transfer methods are not necessarily mutually exclusive.

Private business transfers are accomplished in discrete niche markets that exist only in an ad hoc fashion. In other words, a menu of transfer alternatives is available to match owner motives that ultimately drive the market. This rich range of alternatives has developed significantly over the past 10 to 15 years. Various transfer advisors, including investment bankers and other intermediaries, provide an owner with the methods necessary to convert motives into action.

TABLE 1

Private Transfer Motives

Private Owners Want to:
• Change Their Lifestyle
• Diversify Their Estate
• Create a Family Legacy
• Allow Employees to Continue the Business
• Use Transfer of Business as a Wealth-Creating Vehicle

An owner has seven transfer channels from which to choose:

1. Employees
2, Charitable trusts
3. Family
4. Co-owners
5. Outside—retire
6. Outside—continue
7 Public

The choice of channel is manifested by the owner's motives and goals. For example, owners wishing to ultimately transfer the business to their children choose the family transfer channel. Owners who desire to go public choose the public transfer channel, and so on.

Each transfer channel contains numerous transfer methods, which are the actual techniques used to transfer a business interest. For example, grantor retained annuity trusts, family limited partnerships and recapitalizations are methods by which an interest is transferred. Some methods are exclusively aligned with certain channels, such as an ESOP within the employee channel. Other methods can be applied across channels, such as the use of a private annuity with either the family or outside channels.

When a business interest transfers within the company, or the owner's family, it is called an *engineered intra-transfer*. These are custom-tailored solutions

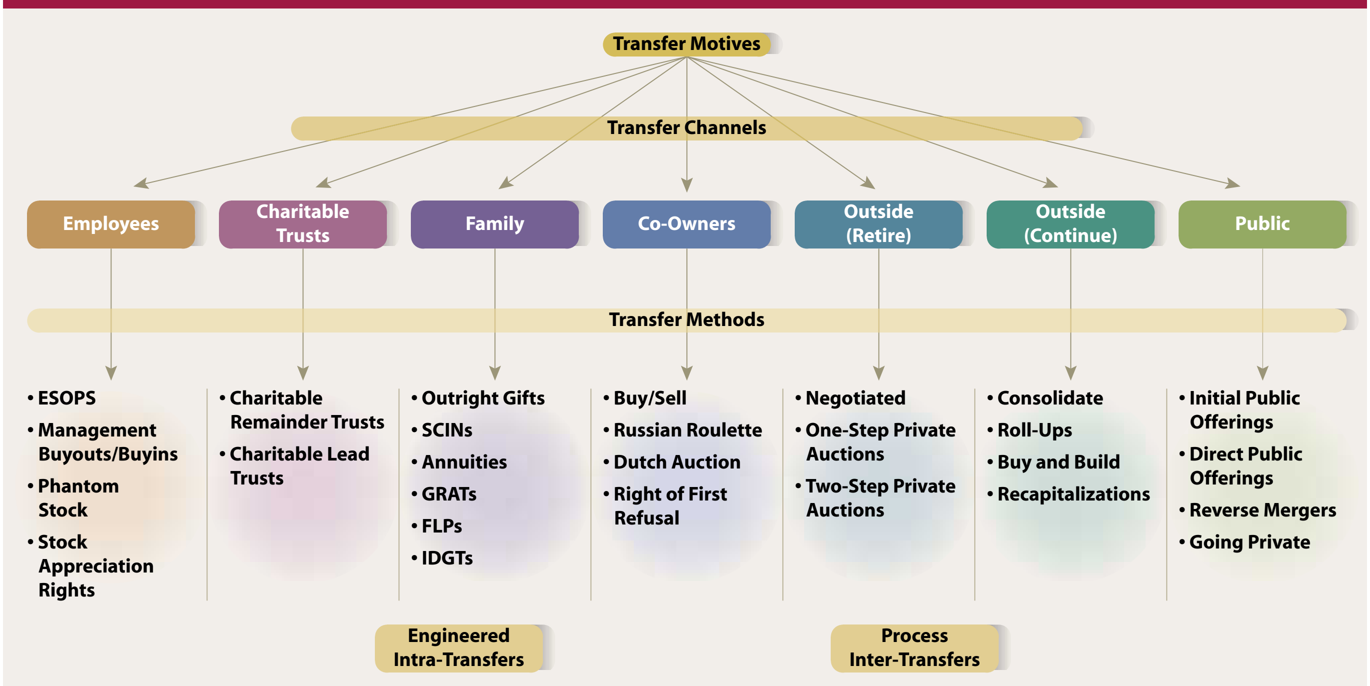


FIGURE 1

Business Transfer Spectrum

designed to transfer all or part of the business internally, without the uncertainty of finding an outside buyer. Examples of Engineered intra-transfer methods include management buyouts, charitable remainder trusts, or family limited partnerships.

Process inter-transfers involve transferring business interests to a party outside the company. Examples include negotiated sales, roll-ups and reverse mergers. As an illustration, an owner who wants to sell his or her business for the highest possible market price might employ a private auction process designed to produce the highest offers available at a given time.

The choice of transfer method leads to a business value. Thus, if an owner is considering several different transfer methods, he also is choosing different values for the business. This thought leads to a discussion of value worlds.

Value Worlds

Private securities do not enjoy access to an active trading market. Either a private valuation must be undertaken, or a transaction must occur to determine the value of a private security *for some purpose*. Purpose is defined as the intention of the involved party as to why a valuation is needed. For example, seeking a fair market valuation of the business to support an estate planning technique is a common appraisal purpose.

The purpose of an appraisal leads to the function of an appraisal. Function is described as the intended specific use of an appraisal. Following the purpose example in the preceding paragraph, a function of the fair market valuation might be to establish a charitable remainder trust or a family limited partnership. Specific functions of a valuation require the use of specific methods or processes, each of which can derive dramatically different, yet accurate, value conclusions. The purposes for undertaking an appraisal are described herein as *value worlds*. Therefore, the premise of value world theory is:

A private business value is relative to the value world in which it is viewed.

Every private company, therefore, has a number of different values at the same time, depending on the purpose *and* function of the valuation.

Who or what decides the appraisal rules within a value world? Each world has an Authority, which is the agent, or agents, that govern the world. The authority decides whether the intentions of the involved party are acceptable for use in that value world, as well as prescribes the methods used in it. For example, the Internal Revenue Service is a primary authority in the world of fair market value. Owners, planners and appraisers who choose to ignore this authority do so at their own risk. For example, gifting stock interests or implementing sophisticated estate-planning techniques without a fair market valuation may invite an unwelcome visit from the

TABLE 2

Value Worlds Concept Chart

Appraisal Purpose	Value World	Appraisal Functions	Responsible Authority
To Find the Highest Value in the Open Market	Market Value	Sale of a Minority or Control Interest, to Support a Merger	Financial Intermediaries
To Find a Value for Tax Matters and for Some Legal Reasons	Fair Market Value	Federal Estate and Gift Taxes, ESOPs, Charitable Contributions	IRS, Federal Law, Administrative Rulings
Shareholder Actions	Fair Value	To Support a Minority Dissent, Oppression Claim	Statutory Law
Shareholder Wealth Measurement	Economic Value	To Create/Measure Management Bonus Plans, Company Performance Measurement, Capital Allocation Systems	Academic Community and Management Consulting Industry
To Determine Insurance Coverage	Insurable Value	To Fund Buy/Sell Agreements, Business Interruption Claims	The Insurance Industry, Involved Parties
To Follow FASB No.142	Impaired Goodwill	To Determine Impaired Goodwill	FASB
To Value Intangible Assets	Intangible Asset	To Value Intellectual Property, Such as Patents and Copyrights, or to Value Intellectual Capital	Intangible Asset Laws (Patents, etc.)
To Value the Business from One Investor's Perspective	Investment Value	Value Specific to One Investor, Probably for Purchase/Investment	The Investor
To Value the Business from an Owner's Perspective	Owner Value	Value Specific to Owner, Probably for Sale	The Owner
To Determine the Borrowing Capacity of the Business	Collateral Value	To Obtain a Secured Loan	The Secured Lending Industry
To Determine the Value of a Start-Up	Early Equity Value	To Derive the Value of a Start-Up to Determine Equity Splits	Venture Capitalists

Internal Revenue Service.

Table 2 lists a number of value worlds, with associated purposes, functions and authorities.

Authorities are found in each appraisal world. For example, insurance companies are an authority in the world of insurable value, especially as it relates to determining certain types of claims. They are responsible for developing criteria and administering methodology used to derive value, as well as sanctioning noncompliance, such as not paying a claim that does not follow prescribed valuation procedures.

The linkage between an owner's transfer motive and the value received for a business now can be established. The intention or motive of the involved party leads to a purpose of an appraisal. The purpose for undertaking an appraisal gives rise to a value world, which sets a value. Here's the critical insight: the choice of transfer method selects a value world, which of course, leads to a specific value. Figure 2 shows this linkage.

Several interesting observations can be made regarding this causal chain. First, channels may house numerous methods, some of which select different value worlds. For example, the Employee channel houses ESOPs, viewed in fair market value, and management buyouts, which may be viewed in market value, investment value or owner value. Second, the left side of the chart largely involves regulated transfer methods, which lead to the fair market value world. The right side of the chart largely involves unregulated methods, which are viewed primarily in market value. The co-owner channel is the dividing line and can be viewed as partly regulated, partly unregulated. Third, by definition, channels with multiple worldviews have multiple world values. Thus, an owner wishing to transfer to an outsider, then retire, might transact in market value, owner value or investment value. Each world has dramatically different value propositions.

The value range concept is extended when one considers that some transfer methods may apply to multiple channels, a concept purposefully not shown in Figure 2. For example, the negotiated transfer method may be employed in the employee, family, co-owner and outside channels. Or management transfers may occur within the charitable trusts, family or co-owner channels. Showing all possible linkages would quickly turn the chart into something only Jackson Pollock would recognize.[3] Perhaps an example of this crossover linkage will help.

Assume a fictitious owner, Joe Mainstreet, wishes to transfer his company, PrivateCo, to his son and daughter. Because all is well with the Mainstreet clan, the transfer occurs in the family transfer channel. Figure 3 illustrates Joe's selected transfer options, along with PrivateCo's value in the corresponding value worlds.[4] Once again, it is important to emphasize that values shown for each value world are derived using a process prescribed by an authority that enforces the legitimacy of the value conclusions within its scope.

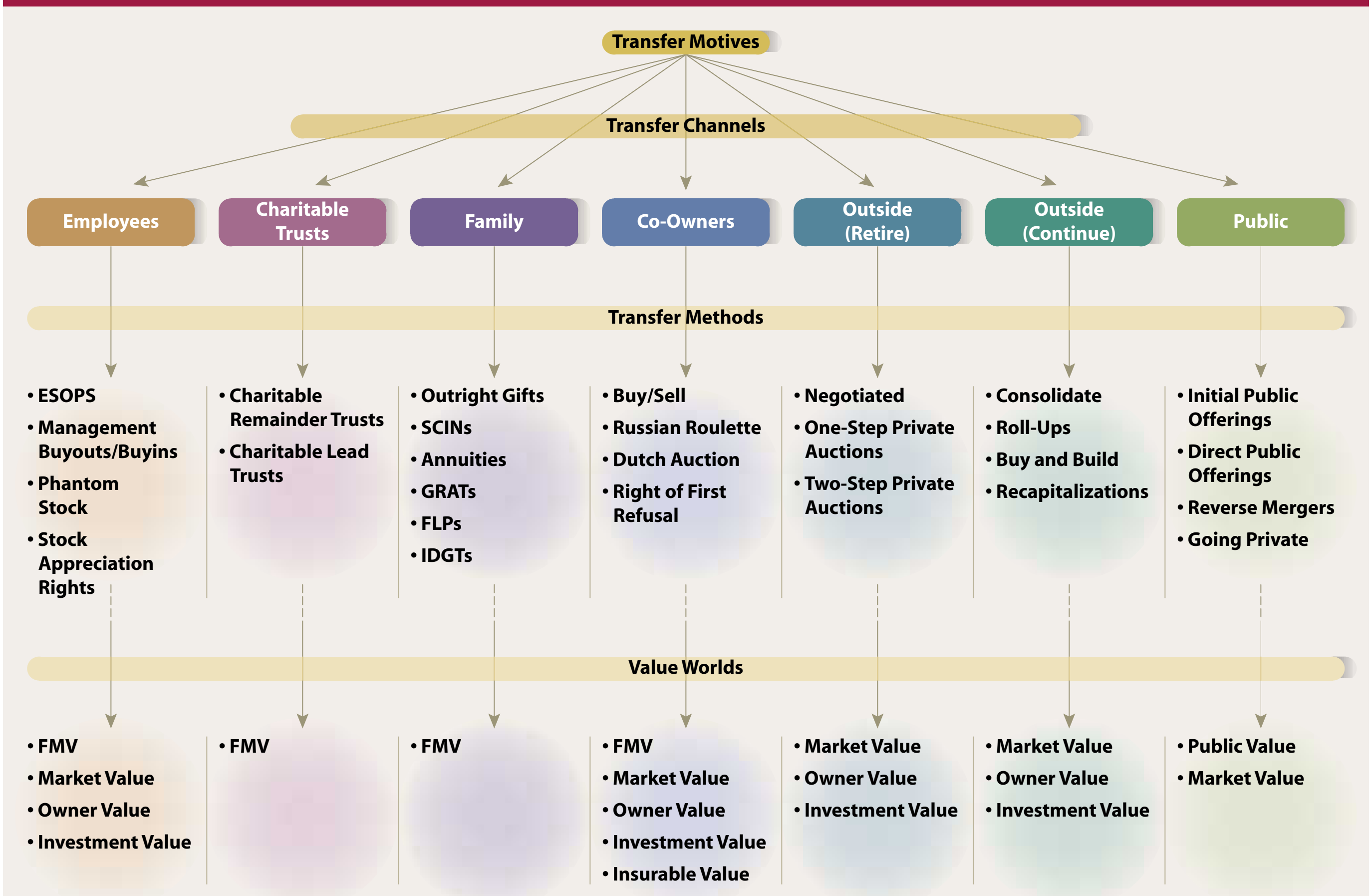
The family transfer channel employs multiple transfer methods, such as a negotiated deal or various trusts. In other words, Mr. Mainstreet can always choose to "work out a deal" with his kids, or stay within the confines of a more structured method such as a GRAT. The main question is, in which value world will the transaction occur? These methods necessarily select four different value worlds, each with a different corresponding value. Joe Mainstreet can choose to transfer PrivateCo to his son and daughter for an amount between $7.5 and $16 million, depending on which value world he selects.

Why is there so much variability in PrivateCo's value? First, every private business interest has *at least* as many values at any given point as the number of value worlds. These "worldly" values are the result of controlling authorities within each world prescribing unique valuation method(s) by which to derive value. For example, in the world of fair-market value, the IRS sets many of the rules for how valuation is performed in their world. The IRS dictates use of the hypothetical "willing buyer and seller" rule, which causes no synergies to be valued between the parties. In contrast, financial intermediaries are the authorities in the world of market value. Intermediaries incorporate synergies into market valuations. Further, investors and owners are the authorities in the investment and owner value worlds, respectively. These players have their own peculiar methods for valuing a business interest, which are very much aligned with their particular interests.

Beyond the different values determined by world, there are nearly an infinite number of values possible within each world. The probability of different value drivers occurring must be considered. For example, if a company earns $3 million and this number is used in the valuation, it is assumed with 100 percent probability that the company will indeed earn $3 million. What if, upon further due diligence and consideration of revenues and cost variables, it seems reasonable to presume the company has only a 50 percent chance of earning $3 million? An independent analysis might further indicate the company has a 25 percent chance of earning $2

FIGURE 2

Linking Motives to Value



million and a 25 percent chance of earning $3.5 million. Wouldn't each of these scenarios lead to three different values, even in the same value world? The answer is yes.

Well-run businesses give owners access to the spectrum of transfer options. To accomplish a successful transfer, the owner should plan a particular course of action appropriate for his or her particular motive, then evaluate available options and finally execute the transfer.

Conclusion

In the remainder of the current decade a large number of private businesses will transfer. Financial planners who understand the workings of the private capital markets are needed to assist owners in successfully evaluating their various options.

Financial planners now should be aware of the following linkage:

- Transfer motives or intentions of a business owner lead to a value world
- Business owners have multiple transfer alternatives from which to choose
- Specific transfer methods are connected to specific value worlds
- Therefore, owner motives choose a range of values

For financial planning to be effective, planners must be able to help clients identify their financial goals, develop strategies that will promote the realization of those goals and ultimately execute tactics to achieve the goals. Understanding the linkage between transfer motives and business values empowers planners to help clients develop and execute their financial plans. This knowledge also enables planners to leverage existing skills, which creates value for the client and the planner.

FIGURE 3

Joe Mainstreet's Family Transfer Options

Channel	Method	Value World	Private Company Value
Family	Negotiated—Work Out a Deal	Investment Value	$7.5 Million
	Trusts—GRATs, IDGTs, etc.	Fair Market Value	$9.2 Million
	Negotiated—Work Out a Deal	Market Value	$12.0 Million
	Negotiated—Work Out a Deal	Owner Value	$15.8 Million

Endnotes

1. Robert T. Slee, "Private Acquisition Prices Drop for Midmarket Sales," *The Business Journal,* May 11, 2001. The survey referenced in the article was performed by IMAP, the International Association of M&A Professionals (www.imap.com).
2. John L. Ward, *Keeping the Family Business Healthy,* 1987: Jossey-Bass Publishers.
3. Jackson Pollock was an American artist known for his "all-over" style of painting.
4. PrivateCo values are calculated in the following book: Robert T. Slee, *Private Capital Markets: Valuation, Capitalization and Transfer of Private Business Interests,* John Wiley & Sons, 2004.