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The Role of a Business Valuation in Succession Planning

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Of all the assets that make up an estate, the most complex and valuable is often the closely-held business. The business represents a lifetime of effort and the source of wealth, income, and great satisfaction. Wrapped up in that business are long-term relationships with key employees, vendors, and customers. It is rare to find a closely-held business that doesn't have some kind of disaster or monumental difficulty in its history that it somehow survived and even became stronger. All of this contributes to a source of pride and joy like no other asset.

These factors also make the discussion of planning for succession all the more difficult. There tends to be a deep attachment to the business and, with that attachment, comes emotions and expectations that often prevent the successful conclusion to a process of establishing and implementing a plan of succession. For those cases where succession planning is successful it is usually driven by the owner's desire for the continuation of his or her life's work and the sense of a legacy being left for the next generation.

The agenda for discussion and resolution in a succession plan includes a transfer of management control, ownership, and influence. Obviously, the individual or group of current owners must recede in control and influence and the "next generation" must increase. While a difficult course to navigate, it is often less tricky than the transfer of ownership. For, in the transfer of ownership the prior generation is severing all legal claims to operations, influence, and control. To the extent that completion of the buyout is dependent on the future success of the business, there is often fear that they may never see the fruit of their labor. All of this, however, is after the settlement has been reached on the value of the business.

What Do You Have?

The first step in succession planning is to understand what the owner has to pass along. Establishing the nature of the business and the ownership interest is critical to accurately and efficiently implementing a succession plan. Putting a value on that interest is easily the most difficult part of determining "What do I have?"

If there is one generalization that can be made regarding the value of the closely-held business, it is that the founder-owner always believes the business is more valuable than it actually is. This is why an early step in any succession plan for a closely-held business is to find out from an independent and objective source what the value of the business is. If this cannot be resolved in the mind of the owner the rest of the succession planning process may be a waste of time. A business owner is likely to eagerly participate in a succession plan if their assumption is that the business is worth $5,000,000. If the valuation process has been deferred to the end of the process and they find out it is really only worth $1,000,000 it is almost a certainty that the planning process will lose steam. If there is that large of a gap between reality and perception it is far better to address the difference early in the process rather than later.

Often, a buy-sell agreement is established to define and memorialize the terms of a succession plan. Included in that agreement should be a discussion of how the business is to be valued at the "trigger" event – death, disability, retirement, etc. The document is important as it is the road map that is to be followed by all parties to the agreement. It is also an important document in the context of an estate plan as it relates to the assessment of estate taxes in the event of death. The tax court (US Court of Appeals Tenth Circuit, Estate of HA True v United States) has stated, "Where the price term in a buy-sell agreement is reached in an arbitrary manner, is not based on an appraisal of the subject interest, or is done without professional guidance or consultation, courts draw an inference that the buy-sell agreement is a testamentary substitute." In other words, for the buy-sell agreement to have credibility with the IRS and tax courts, an appraiser should be involved contemporaneously in the development of the valuation portion of the buy-sell agreement.

The Cost of the Appraisal

It is, therefore, advisable that valuation of the ownership interest be the first step in the planning process and that a valuation professional be retained. Often this stymies the process because of the expected cost of doing a valuation compared to the perceived benefit. However, the cost can be minimized and the benefits enhanced with proper planning and the use of an appropriate valuation firm. It is not necessary to pay for a "full" appraisal of the business. A full appraisal produces an opinion of the value of the business accompanied by a thick report containing all the factors and assumptions behind the opinion of value. Not only is this level of assurance not needed, it is almost never actually read or considered useful to the business owner.

This is a similar scenario to building appraisals that are costly and rarely read beyond the front page of the report where the value opinion is stated. A market comp report from a real estate agent is a free way to get a ballpark value of a piece of real estate. While certainly not free, a less expensive and more useful exercise is to hire an experienced business valuation expert to provide a short-form report that provides a range of estimated value for the ownership interest. Finding out that the business is valued within a general range based on market transactions and/or accepted valuation formulas is an adequate level of precision. Since the actual price of the transfer will be negotiated it is of limited usefulness to purchase an opinion of value and all the work that goes into that opinion.

The Business Appraiser

A well-selected valuation expert will have the ability to determine the range of value, explain the basis for the conclusions, and assist the seller (owner) in understanding how the business is valued. The right expert is critical to the succession planning process. If the appraiser cannot bring the seller to a conclusion of reasonable value, then the rest of the process, as has already been described, is probably in jeopardy.

For example, one of the key factors in the valuation of a business is reasonable compensation of the owner(s) who is active in the operations of the business. A discussion regarding the fact that the owner is overpaid for the services they render to the business is a difficult conversation. Bringing the owner to the understanding that such a circumstance actually results in a higher valuation conclusion seems to be counter-intuitive to the owner and often offense is taken at the premise: "You are overpaid." This is an example of the "de-personalization" that must take place for the successful transfer of a business from the founder to the next generation. The appraiser should be able to play a key role in assisting the owner to begin the process of detaching their emotions from the succession planning process.

What to Do With the Appraisal

The process of valuing the business is often fairly short. However, the process of the owner/seller agreeing to the value is often much longer. As already generalized, the business owner will believe the value of the business is much greater. This should be expected as the owner is aware of all the sleepless nights, painful decisions, tight cash, and other significant difficulties that were endured in order to establish the consistent cash flows that are being valued.

Once the general value of a business is determined the succession planning process can proceed. The business owner (seller) now has the information needed to decide whether they actually do want to sell out and, if so, what terms (timing, cash flow, etc.) they would be willing to accept in the planned diminution of their ownership, influence, and control.

The seller (business owner) often has in mind who the buyer might be. Both the terms that the seller will accept and the nature of the negotiations will be dependent on the relationship with the potential buyer. The knowledge gained in the valuation process should assist the business owner in understanding the actual cash flow of the buy-out transaction once the succession plan is in the implementation stage.

While a highly valuable business may be out-of-reach for the pool of potential buyers the business owner might have anticipated, a lower valuation than anticipated may open up the possibility that current management or partners could easily accomplish the buy-out. When negotiating the transfer of the business, knowing the estimated value of the business allows the seller to assess whether the buy-out can be reasonably financed through the business operations. This might make the purchase more attractive by current management and/or employees.

It may be that the initial valuation estimate is lower than it might otherwise be if a few changes to the business are made. This information is valuable id the current owner (seller) has the time and wants to make the changes before putting the business up for sale or establishing the plan of succession with employees or family. This is similar to the process of selling a home. If the real estate agent states the estimated market value based on neighborhood "comps" but then suggests that new window coverings and a paint job would greatly improve the marketability and price of the home, then the seller would certainly consider doing those things.

Who Needs to Know About It?
It is advisable that all the parties to the succession plan be included, early in the planning process, in the discussion of the business valuation. It is fairly common for the business appraiser to sit down with the business owner first and then with individuals selected by the owner (family, employees, etc.) to review the methodology of valuing the business and the estimated value. As long as such a meeting is conducted as an informative and educational meeting rather than a persuasive or negotiating meeting, it is generally very cordial and helpful to all parties. The education provided in such a meeting reduces the temptation to question the validity of information provided in the eventual negotiation process.

Such a meeting should not be used by the business owner to dissuade the succeeding owners from doing their own work to determine the value of the business. It is common, however, to hear the potential buyers state up-front that they want to get their own appraiser but then after the meeting with the seller's appraiser the negotiations then begin without the use of a second appraiser. This saves everyone time and money.

Conclusion
Succession planning for a closely-held business is dependent on complete and accurate information for all parties involved. The foundation of this process is the use of an independent and object business appraisal expert who can assist the owner in understanding the factors affecting the value of the business and ultimately knowing what it is the owner has to pass along to the next generation.

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