GRYPHON VALUATION CONSULTANTS, INC.

Business Valuations: Value Your Business Internally and Externally

While preparing your succession or estate plan, it can be helpful to value your family business both internally and externally.

You might wonder what that means — because you think your company has just one value. In fact, it can have multiple values depending on the valuation standard used. The different results can help you determine whether to keep the family business, pass it on to the next generation or sell it to an outsider.

Two common standards used in valuing a family business are:

1. Investment value. This gauges internal value, which represents the value to a particular investor based on individual investment requirements and expectations. In layman's terms, it is what the business is worth to the current owner(s).

2. Fair market value. This is the external value and refers to the price in terms of cash equivalents at which the property would change hands between hypothetical willing-and-able buyers and sellers if:

- They are acting at arm's length in an open and unrestricted market;
- Neither is under any compulsion to buy or sell; and
- Both have reasonable knowledge of the relevant facts.

In layman's terms, this is what you can expect to get when you place your business on the market to sell to a qualified buyer.

The relevance of these two valuations lies in their differences. The investment value of an operating business could be higher or lower than the fair market value. That difference is driven by the actions that "control owners" take in their best interests. As examples, owners controlling a family business can often take advantage of:

Compensation. Owners have the flexibility to pay themselves higher-than-market compensation. A buyer in a fair market transaction has to pay only what the market requires to replace the owner's compensation. In a family business, family members are on the payroll and also may receive more than market compensation. In addition, these family members may be employed only because the business is held in the family. If the business is sold, the new owners might not retain any family members or pay their high salaries, if they are kept on.

Fringe benefits. Owners in control of a family business can also manipulate fringe benefits. For example, they and family members may have life insurance, disability insurance, or health insurance that the company pays for. A new owner may not be able or willing to match that benefit. The business might also own an airplane or a vacation home and offer a liberal expense policy. These ownership benefits are not likely to be retained by a buyer and that creates a difference between the investment value and the fair market value.

Related-party relationships and transactions. A family business might rent its business property from a related party, often for an amount higher or lower than the fair market rent. If the business is sold, the property might be at some economic risk. The attractiveness of the property to an outside buyer should be taken into account as these related-party transactions can have an impact on fair market value.

Changes in capital structure. Owners controlling the business have the power to maintain or change the capital structure of the business. In many cases, the capital structure is not ideal for the business. It often under-utilizes debt and that deflates value on a fair market basis

The bottom line is that these variations generate a difference in the value to the current owner (the investment value) and the value to a potential buyer (the fair market value).

You need to account for these differences in arranging succession, exit and estate plans. The values can help you decide what to do with the family business. Keep in mind that the effect of suddenly not owning a business can be considerable, both on you and family members, especially if you have not considered the different valuations. This needs to be part of planning your estate, as well as the estates of relatives involved in the business as partners.

Along with your business and estate planning advisers, Gryphon Valuation Consultants, Inc. can be a valuable asset in making the assessments and determining the effect of selling compared with retaining ownership within the family.

Gryphon Valuation Consultants is a full-service professional business appraisal firm offering a broad range of valuation and litigation consulting services. If we can serve your valuation needs, or if you have a question about our services, please contact us at 702-870-8258 or visit us on the web at www.BizVals.com. Gryphon is an independent member of the American Business Appraisers National Network.