Price, Not Value, Is a Product of Negotiation

Price is usually the most difficult hurdle for buyers and sellers to overcome. The value of a business is different for each party participating in a transaction and is based on opinion and the specific set of circumstances for each individual. Price, on the other hand, is the number at which the transaction is executed. Yes, value informs price, but it is not the only influencer. Price is also the result of good faith negotiations between buyer and seller. While negotiation does not necessarily impact each party's perception of value, it allows for dialogue so that both sides arrive at a price where the value for each individual overlaps and a mutually beneficial deal can be struck.

How Much is My Business Worth?

The answer is: It depends. What are the circumstances of the valuation? Experienced and certified appraisers can provide guidance, insight, and consultation to help inform buyers and sellers regarding the buyer's perceived value of specific types of property. However, in order to answer the question of value and to produce a relevant report, the appraiser needs to understand why the valuation is being performed.

Ultimately, valuation is a function of purpose. For example, the sale of a practice on the open market versus a valuation on the same practice for another purpose, such as tax reporting or disputed matters, may result in widely different values. IRS Revenue Ruling 59-60 requires Fair Market Value (FMV) as the standard of value to be expressed in terms of cash or cash equivalents. This all-cash value basically assumes that a check is written at the time of the transaction for the full price.

However, in an open-market sale, buyers rarely take the risk of paying 100% cash at closing to acquire an intangible, personal, services-based practice. Deals are typically structured with terms that include a portion of the price paid up front with the balance financed on a performance-based promissory note. The deal structure plays a crucial role in determining price, not value.

Payments over time should account for the time value of money, the risk the seller takes on of potentially not receiving future payments, and the recourses associated with a buyer defaulting on payments. These are important considerations and generally buyers and sellers agree to a premium over a cash value. The takeaway here is that it is important to identify and understand the intentions and needs of both buyer and seller.

How Do I Realize the Greatest Value for My Business?

As discussed above, deal terms play a major role in determining the most probable selling price. However, negotiations are the basis for determining the actual price. Value and price may be similar concepts, but they are not inextricably linked.

The value of a business is the buyer's perception of whether the monetary worth of the business is equal to its net present value of future expected cash flow. In contrast, price is the value of that business adjusted for the terms of the transaction. In essence, value is the business's worth in relation to an individual's perspective, whereas price is the negotiated value considering all relevant factors of the deal. If the value is not adjusted for the negotiated terms of the deal, the value of the practice may be materially increased or reduced.

Consider the following example: Advisor X sells his practice for $1.5 million, is paid cash at closing, and 100% of the price is allocated to capital assets resulting in long-term capital gains tax treatment. Advisor Y sells his practice for $1.5 million for 30% down at closing and finances the balance over five years with 80% of the price allocated to capital assets resulting in long-term capital gains tax treatment. The buyers in both scenarios paid the same price for the practice, but as a result of the deal terms, the value each seller received is different. Ultimately, value is a stepping stone for a buyer and seller to arrive at an agreed-upon price.

The agreed-upon price does not need to equal the value or, if deal terms are included, the price expressed in a valuation report. The value or price expressed in the valuation report is an opinion and should be used as a starting place for further negotiations.

Sellers that realize the highest prices effectively communicate and demonstrate historically reliable, predictable, growing cash flow, as well as cost savings and synergies to be created as a result of the acquisition.

Successful transactions require cooperation between the buyer and seller and are not wholly dependent on the valuation result. This is often difficult for practice owners to absorb. After all, in financial services most numbers are absolute and do not vary. However, when it comes to the value and price of an advisory practice, there can be, and often is, a range of value. The deals with the highest success rates result from both buyer and seller understanding that value can vary and that deal terms play a major factor on the final price. Effective communication in the negotiation process is equally critical.

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