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Editor's Column: Are Closely Held Businesses Marketable?

Paul R. Hyde, EA, MCBA, BVAL, ASA, MAI

I recently read with a great deal of interest a thread called “‘Control, Marketable’ is an Oxymoron” in a business appraiser discussion group. Numerous well-developed and interesting opinions were expressed by business appraisers and the thread inspired me to spend some time considering my own thoughts on the issue.

I have worked, first as a business broker, then as a business broker-business appraiser, and finally as a full-time appraiser only for many years. Years ago I remember struggling to help a business owner come up with an asking price that made sense – it was tough, many owners wanted to base the asking price on what they needed to get out of the business to maintain their lifestyle rather than on anything having to do with actual business profits. I also found that some owners were willing to list their business at an unrealistically high price just to see if there was someone out there that might pay it – if so, they would retire. Some business owners that really needed to sell the business quickly due to health issues or some other motivating factor wanted to know what incentives were needed to move the business quickly. Most of the businesses I sold during my years as a business broker fall into the category of Main Street businesses, i.e. mom and pop sized businesses in which the buyer was typically purchasing a job. While I sold a few large businesses, none of them were what is typically referred to as a middle market business. A review of my records revealed that about 10% to 20% of the Main Street businesses listed for sale actually sold. There are many reasons for some really nice businesses failing to sell over a year or two marketing period other than asking price.

In my experience, many people interested in buying a business were typically those that left corporate America, either voluntarily or involuntarily, and decided that they wanted more control in their working life. Most usually expressed an interest in a specific business when they first called; however, any kind of small business that produced income large enough to meet their income requirements was of general interest. I found that most serious buyers looked at several business opportunities and purchased the one that seemed the most “enjoyable” to operate to them. It was not a rare experience to get a call within a year or two to resell the business as it was not as “fun” as initially expected.

Buyers and sellers of Main Street businesses are typically not very sophisticated, and decisions are based more on feelings and common sense than rates of return and financial data. Conversely, investors in larger businesses, middle market and larger, tend to make decisions based on multiples, rates of return, etc. They also are much more likely to have true financial professionals review deals and provide advice than are mom and pop buyers and sellers who may go to the “family attorney” or “tax preparer” for advice.

The percentage of middle market companies that actually sell is apparently quite a bit higher than Main Street businesses. A number of brokers and others associated with this market represent that 40% to 60% of businesses for sale actually sell.

The question that appraisers deal with regularly is this: Are control interests, primarily 100% interests, in closely held businesses marketable?

The answer is largely based on the definition used for marketable. The International Glossary of Business Valuation Terms states that Marketability is "the ability to quickly convert property to cash at minimal cost." Based on this definition, all privately held business interests are not marketable, i.e. they take a while, typically much longer than three days, to convert to cash. This does NOT mean that they cannot be sold. They often can be sold, but it will typically take time to package them, market them, finance the purchase, and close a transaction. Many things can and often go wrong during this process: i.e., the attorneys for buyers and sellers fight over wording, the accountants push for a change from an asset sale to a stock sale, a lender wants additional collateral, etc.

Some argue that the term liquidity should be used instead of marketability. Liquidity is defined by the International Glossary of Business Valuation Terms as "the ability to quickly convert property to cash or pay a liability." I don't think it matters, as long as we carefully define the terms we use and stick to them.

In my opinion, the critical thing to remember is what Ray Miles refers to as "marketability is relative." According to Ray, "the marketability of a subject business can only be determined by comparison with some reference." For example, if we use the Direct Market Data Method, all of the sales are sales of control, non-marketable businesses, i.e., one hundred percent ownership interests of closely held entities. There is no need to apply a discount for lack of control or a discount for lack of marketability to the conclusion using the Direct Market Data Method when appraising a 100% interest in a privately held business – all of the companies in the database have similar control and marketability characteristics. If an appraisal method is used that has different control and marketability characteristics, then discounts will likely be necessary to convert the value conclusion so that it is similar to the business in question.

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NOTE:

This is my final issue as the editor of *Business Appraisal Practice*. I have been the editor for almost eight years and it is time to let someone else take over. I have enjoyed the work and hope you, the readers, have benefited from the articles. I appreciate those of you that have written articles for this journal, those reviewers that have taken their time to make sure that the articles are appropriate and well written. Most of all, I want to thank Ray Miles for his efforts. Ray has done the final review of each and every article throughout my tenure as editor. He has done a great job and provided a great service to us all.

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