Synergy: Not Part of a Fair Market Value Business Appraisal: Why sellers think their business is worth more than the appraised Fair Market Value

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"My business is worth a lot more!" is a fervent exclamation business appraisers often hear when sellers learn the result of a fair market value appraisal. Often this reaction is due to the seller's confusion between fair market value and investment value. This article demonstrates:

- how synergy, the generally accepted term for the difference between fair market value and investment value, influences this recurrent reaction from the seller
- how synergy is divided between the seller and buyer
- how modeling can be used to estimate the value of synergy
- how a business appraiser can help a seller increase the value of his or her business

Fair Market Value

The Fair Market Value of a business is defined with either of the following definitions. They are substantially the same, but come from different sources. According to Revenue Ruling 59-60, the Internal Revenue Service's cornerstone ruling regarding valuation of privately held companies:

> *....fair market value... the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts.*[1]

The other definition, often used outside of tax matters, is provided by the International Glossary of Business Valuation Terms:

> *Fair Market Value—the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.*[2]

Synergy

Nowhere in either definition is the word *synergy* mentioned. What is synergy? As an analogy, we can explain synergy with the formula: $2 + $3 = $6.

Assume the seller's company has an appraised Fair Market Value of $2, and the buyer's company has a presumed Fair Market Value of $3, then the combined companies may realize a Fair Market Value of $6 (plus or minus); i.e., more than the sum of the parts. The additional $1 in the total value is the *synergy* created from many potential opportunities in combining the two businesses:

- Reduction in costs from lowering overhead, combining benefit programs, increasing purchasing power and a host of other possible cost reductions
- Increase in revenues from combining or widening distribution channels, broadening the product or service offering to the customers, improving pricing power, etc.
- Reduction in total investment from eliminating duplicate facilities and equipment, reducing inventories, combining technology and other intangible assets, etc.

Relating to a Business Appraisal

No portion of the additional synergistic $1 enters into a Fair Market Value appraisal. Fair Market Value is the value of the willing seller's business as the stand-alone entity that could be purchased by a willing buyer who may or may not have opportunities to create any synergy.

The question becomes, "Should the seller or the buyer receive the extra $1 of synergy created in the combination?" The seller's gut feeling is that his or her business is worth more than the appraised Fair Market Value. When synergy is considered, the seller's gut feeling has some validity. Why?

The answer lies in the potential opportunities for synergy mentioned previously. The seller's argument is: "Look at all the opportunities the buyer gets to improve both companies when they are combined; I should get the extra $1

for bringing these opportunities to the buyer." The buyer's argument is: "The only way the combined companies are going to realize those opportunities is if I purchase the seller. I should get the $1 for completing the deal."

Separately both arguments make sense. In reality, both buyer and seller will likely share in the $1. However, when the two arguments are laid next to each other, the buyer usually comes out with a greater share of the $1. The buyer is laying out the money and has the burden of turning the potential synergistic opportunities into reality to achieve the combined $6, while the seller may be off fishing or golfing with the buyer's cash.

Investment Value

According to the International Glossary of Business Valuation terms:

> *Investment Value—the value to a particular investor (buyer) based on individual investment requirements and expectations*.[3]

The important difference between Fair Market Value and Investment Value is the identification of a *particular buyer* as compared to a *willing buyer* or *hypothetical willing and able buyer* used in the previous Fair Market Valuation definitions. One *particular buyer* may perceive the value of the synergy as being greater than $1. Another *particular buyer* may perceive the value at less than $1. Another *particular buyer* may perceive negative synergy, i.e., the value of the business to that *particular buye*r is less than the appraised Fair Market Value.

Similarly, even with the same value of the synergy, one *particular buyer* may offer a larger share of that value to the seller than another *particular buyer* may offer.

The Investment Value of the seller is the $2 plus a fractional percentage of the total synergy, i.e., a fractional part of the $1, which a *particular buyer* offers the seller.

Reassuring the Seller—Unrealized Synergy

The seller's gut feeling about the value of his or her business usually contemplates those *particular buyers* where the seller perceives large potential synergies.

Appraisers should explain to a seller what synergy is, i.e., the $1, and that Fair Market Value does not include synergy. Appraisers should further explain that the Investment Value may be materially higher than the Fair Market Value depending on the *particular buyer*.

Finally, appraisers should emphasize that the potential synergy created in a combination of the two businesses is not yet a reality. It is probabilistic whether the synergy will happen and what value the synergy will actually add to the combined entities.

Estimating the Value of Synergy

When an arms-length transaction is contemplated, estimating the dollar value of synergy, i.e. the actual value of the $1 in our analogy, is critical for setting an asking price and for negotiating a final price.

Buyer's appraisers have a *particular buyer*, their client. Analyses of both companies will reveal opportunities for synergy in the combined company. Estimating a monetary value of these synergies is possible, albeit with a large potential for error.

For example, the appraiser may determine the investment value of a seller located in a territory adjacent to the buyer. Both companies have sales personnel in their respective territories and the product lines are complementary to each other. With input from sales personnel from both companies, the appraiser may arrive at an estimate of the combined incremental sales and hence the value of the incremental cash flows.

Other areas for increasing revenues, decreasing costs, and reducing investment were previously mentioned. As a larger combined company, opportunities for financial synergy may exist from improved buying power, borrowing power, and creditworthiness. The sharing of technology, research and development, and intellectual properties can also add value.

Appraisers working from the seller's side can only identify potential opportunities for attaining synergy as there is yet no *particular buyer*. Monetizing these opportunities is more subjective.

Modeling different hypothetical buyers with different synergistic opportunities is one approach to estimating the value of the combined companies. Consider the classic horizontal integration model compared to a vertical integration model. In a horizontal integration, increased sales from merging the product lines and territories may be the paramount contributor to the synergy as suggested in the previous example. In a vertical integration, reducing costs in the flow of the product from one stage of production or distribution to the next stage may be paramount. Both models can be monetized.

To determine an investment value, the seller's appraiser must realize that the values of all the potential synergies cannot all be added together; they are not all applicable to a *particular buyer*. Seldom would a *particular buyer* offer both horizontal and vertical integration possibilities.

After examining multiple models based on various hypothetical buyers, the appraiser should select the most likely model as a basis for determining the synergy and therefore the investment value. This investment value is then an important factor in setting an asking price.

Once a *particular buyer* indicates an interest in the seller, then the appraiser is in a similar position as

the buyer's appraiser. Analyses of both companies will reveal the opportunities for synergy in the combined company and monetizing becomes easier. This information is important for negotiating the final price for the seller.

When estimating the value of synergy, whether acting as buyer's appraiser or a seller's appraiser, a healthy dose of skepticism is warranted as pointed out in the next section.

Risk of Attaining Synergies

The value of the synergy included in the Investment Value, i.e., the $1 (+/-) to carry on the analogy, is a hypothetical amount based on the buyer's perception of future events. In determining a stand-alone Fair Market Value of the seller, an appraiser discounts the projected net cash flows of the seller based upon the risks of attaining those cash flows. The appraiser does not project and discount possible synergies that are dependent on a *particular buyer*.

Obviously, the magnitude and the relationship of the numbers used for this analogy are only for illustration. The important consideration is that combining a buyer's company and seller's company may create an entity that is worth more than the sum of its parts because of synergy.

What is the risk of attaining the synergies? Here is a recap of some findings regarding business combinations:[4]

- 61% fail to earn back equity capital invested within three years (McKinsey)
- 50% of mergers erode shareholder value; 33% produce marginal returns (Mercer/Business Week)
- 66% are financially unsuccessful (Coopers & Lybrand)
- More than nine out of ten mergers fail to achieve their objectives (Hay)
- Fewer than 50% of mergers and acquisitions achieved their hoped-for cost savings and barely half deliver their expected revenue (Accenture)

It is no wonder that buyers are hesitant to offer the share of the synergy that the seller thinks he or she deserves.

Additional Business Appraiser Services

Business appraisers are in a unique position to help a seller understand synergy, to potentially improve the synergy, and hence to increase the total Investment Value realized by the seller. At the end of an appraisal assignment, the appraiser is likely to know as much about the disclosed strengths and weaknesses of the overall business, historically and prospectively, as anyone in the company with the exception of the owner(s) and key top managers.

An appraiser can offer additional services in three areas:

- Emphasizing the presentation of the strengths of the seller to increase the buyer's perceived synergy
- Making recommendations to improve the seller's weaknesses
- Identifying prospective buyers who might perceive a higher Investment Value because of the buyer's needs, investment requirements and expectations

However, there is a caveat. Additional services may change the role of the business appraiser to one of a consultant, broker or a mergers and acquisition intermediary. And with that change, the appraiser's role is also likely to change from an independent, disinterested third party to an advocate for the seller. If later circumstances (legal, tax or otherwise) require turning back the clock to the specific point in time at which the appraisal was complete but before the additional services commenced, it could be difficult to uphold credibility as a disinterested party either at that earlier time or later.

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ENDNOTES

1. Rev. Rul. 59-60, 1959-1 CB 237
2. http://www.go-iba.org/resources/glossary.html
3. http://www.go-iba.org/resources/glossary.html
4. http://www.eqmentor.com/managedcontent/sales/docs/Need%20-%20MERGER.pdf