

STRIVE STRATEGIES

Family Business Valuation Metrics Viewed Six Ways to Sunday



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By: Jesse J. Gillett, CPA/ABV, CFE

Our team has dealt with family business valuation matters of all shapes and sizes over the years. The purpose of this piece is to inform the reader that context can have an overwhelming impact on properly measuring value. While this article provides six rough contexts, and outlines various sub contexts, it is by no means all inclusive. But as family business stakeholders form perceptions of what companies and shares are worth, it is important to understand that context matters and can drive a wide range of measurements.

CONTEXT 1

A Basic, Hypothetical, Controlling Valuation

Purposes: For planning/succession, transactional, insurance matters, etc.

Many valuation needs require a corporate, controlling level of value on a hypothetical fair market value basis. This does not typically mean that the value of the company is maximized in some specific, blueprinted manner. It is not a context of finding the perfect strategic buyer. But what this level of value will capture is a reasonable view of controlling owner benefits, quantifying current value using reasonable rates of return and other factors.

This basic controlling value would capture the returns embedded in excessive compensation to owners, family members, etc. – including not just gross compensation, but also any excessive benefits, perks or personal expenses. This valuation would also adjust for excessive and/or below-market payments to related parties, such as a real estate holding company under common ownership that is collecting above or below-market rents.

What this hypothetical controlling valuation would not typically do is to start assuming very specific identifiable cost savings of an actual transaction (e.g., they buyer's bookkeeper will do two jobs, so as the seller I'm eliminating the cost of my



own bookkeeper). This hypothetical control value would not typically assume accelerating growth or de-risking that might occur from combining the company at hand with a very specific buyer. Considering the cost savings and benefits from a merger would fall under a synergistic valuation, which is different than the type of valuation described above.

What is Fair Market Value?

- Considers a transaction between hypothetical buyer and seller
- No compulsion to buy or sell, but parties are willing/able to transact
- The parties have reasonable knowledge of relevant facts
- Price in cash equivalent terms¹

¹ As summarized from the International Glossary of Business Valuation Terms and IRS Revenue Ruling 59-60.

Scenario	Past Cash Flow	Short-Term Growth	WACC	Long-Term Growth	Cap. Rate	Projected Benefit Stream and Present Value Thereof						
						Projection Years>>>					Value Beyond	Present Value
						Yr.1	Yr.2	Yr.3	Yr.4	Yr.5		
Base	\$ 1.00	3.0%	23.0%	3.0%	20.0%	\$ 1.03	\$ 1.06	\$ 1.09	\$ 1.13	\$ 1.16	\$ 5.97	\$ 5.15
De-Risked	1.00	3.0%	19.0%	3.0%	16.0%	1.03	1.06	1.09	1.13	1.16	7.46	6.44
Cost Savings	1.25	3.0%	19.0%	3.0%	16.0%	1.29	1.33	1.37	1.41	1.45	9.33	8.05
More Growth	1.25	9.0%	19.0%	3.0%	16.0%	1.36	1.49	1.62	1.76	1.92	12.38	10.03

CONTEXT 2

Justifying A Strategic Controlling Valuation

Purposes: For transactional matters

If there is an actual transaction in mind, with an actual buyer or a short list of interested buyers, controlling value can become far more intriguing. For example, the seller believes there will be costs to eliminate, complimentary products or services and sales channels that will accelerate growth post-transaction, or aspects of combining businesses that will improve the risk profile of one or both parties.

The basic, hypothetical controlling value perception may now be advanced by a meaningful margin by the time specific favorable conditions are taken into account. Layers of improved assumptions can have a dramatic effect. The table above illustrates how three roughly 25% improvements to valuation assumptions nearly double valuation. While a little extreme, the point is that improved assumptions in a strategic transaction can build up meaningful additional value measurement.



CONTEXT 3

A Noncontrolling, Nonmarketable, Share-Level of Value

Purposes: For gift/estate matters, employee incentives, buyouts, redemptions, etc.

Contexts 1 and 2 represented relatively large values on the private company value spectrum. With that in mind, starting at the basic controlling value in the first instance, and assuming an uncomplicated capital structure, next there is a pro rata (i.e. proportionate) value of lesser blocks of ownership in a company. For example, a 10% pro rata share of a corporation's equity one dollar would be 10 cents. But in certain contexts, that pro rata share is likely to be discounted.

Using fair market value, and barring any agreed upon modification to that value, we now introduce the concepts of discounts for lack of control, discounts for lack of marketability, and sometimes nonvoting discounts (or conversely, voting premiums) among other issues. For example, if one could argue that noncontrolling shares are first worth 10% less for their relative absence of corporate/governance control, and another 30% for the absence of marketability (the author made these percentages up arbitrarily and for illustration only), then the 10 cent pro rata value is not the actual fair market value. Instead, 10 cents minus 10% is 9 cents, minus another 30% is approximately just over 6 cents, mathematically speaking. That is your fair market value in this hypothetical example.

So, the point is, in certain instances your slice of the pie might be worth less than your proportionate share of the whole pie.





CONTEXT 4

Valuation of Shares as Governed by Agreed-Upon Value Definitions

Purposes: For various reasons in a shareholder agreement, operating agreement, etc.

Private company business owners may have certain circumstances in which the value of their shares is influenced by way of governing agreements. In these instances, the direction provided in agreements will range somewhere between very obvious, to the territory of extreme ambiguity requiring careful interpretation.

Agreements may spell out when and how one or more appraisers might be needed. Or the documents may point you to an annual determination made by the board. Or any number of things might be expressed in the agreement as to valuation and buyout type matters.

Agreements may be silent on whether or not shares should be discounted. Agreements might tell you to determine corporation value and simply divide by the number of shares. At times, a mechanical valuation is expressed. There is no telling how to measure value until you thoroughly review the agreed upon terms, determine if they apply, and ensure consensus, if appropriate, as to the applicability of the terms.

CONTEXT 5

Valuation of The Whole, or Specific Shares, for Family Law or Other Legal Matters

Purposes: Divorce or prenup, shareholder litigation, etc.

This context is dependent on jurisdiction-specific definitions typically by way of law and/or precedents. It is helpful to know, when you are not already aware, what your lawyer knows and how he/she would guide you on the standard of value for your case. Typically, this is a question of whether or not the valuation is discounted or undiscounted but beware the consequences of not adhering to the relevant guidelines which may or may not be that simple.

We have performed valuations for several purposes including pre- and post-nuptial agreements, marital dissolution, family business legal disputes, and for post-reconciling planning purposes. In all cases, it is imperative to know the relevant standard of value, and whether that has consequences on the level of value needed, and other important nuances.

CONTEXT 6

Valuation For Various Compliance Reasons

Purposes: Complying with your rules and those of others

This is a little bit of an expansion going back to Context 4 (Valuation of Shares as Governed by Agreed-Upon Value Definitions). A shareholder agreement, or equivalent document might express that every so often, you just need a valuation for some purpose or another. For example, the board needs to do this annually, because the shareholder agreement dictates such. But there are compliance reasons beyond companies' own internal rules. Your family business might be sophisticated enough to have to do valuations for financial reporting purposes, for tax compliance purposes (e.g., for certain reorganizations), to comply with certain requirements of lenders, industry-specific needs, and so forth.

WHAT TO DO

Sometimes family business stakeholders know what to do in these varying contexts. Perhaps they have experienced each of the different situations in the course of a long family-business history. In situations where family businesses are approaching a milestone or major event (transition planning, gifting, dispute, etc.), it is most beneficial to consult with outside professionals (e.g., lawyers, accountants, business valuation experts, family business consultants) early on in the process. What may seem like an early time to consult professionals, often can be the most cost-effective solution, as the professional can guide the family on the appropriate path and assist with the proper documentation to begin to gather.



ARTICLE BY:

Jesse J. Gillett, CPA/ABV, CFE

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