



## THE HIDDEN VALUE OF INDEPENDENT VALUATIONS

*Something to Consider Before Buying a Private Businesses*

### EXECUTIVE SUMMARY

When considering the purchase of a private business, buyers generally focus on what type of business to purchase, its location, the asking *price*<sup>1</sup>, and being able to afford making an offer around asking price. This article illustrates the value of hiring a qualified business valuator to analyze the specific business under consideration and provide you with a report outlining the *fair market value*<sup>2</sup> of that business, before you make an offer. We describe a real example of a buyer-side engagement and provide figures that highlight the hidden value of investing in a professional valuation as part of your due-diligence.

### THE TIME IS RIGHT

Whether you've recently left the corporate world, come into an inheritance, or just feel the inner call, you're about to set out on a new course as a business owner. Not everyone has a specific idea for some novel or new business, for many it's about searching for a business to buy and grow. Lists of businesses for sale, particularly for small to medium sized companies, are typically the result of business owners engaging a business broker to market and sell their company. Not surprisingly, this is where potential buyers can spend hours reading about companies they might buy. But how are those asking-prices determined?

### BUT NOT SO FAST

As independent business valutors, we generally see small-to-medium sized private companies being priced by either a business broker, the company's accountant, or the owner themselves. These prices can provide thoughtful and informed assessments of the business, but not always unbiased indicators of value. It goes without saying that a seller wants the highest price possible. This desire often aligns perfectly with the relationships business owners have with their accountant as well as the goals of business brokers.

But that does not necessarily mean the asking *price*, as advertised, tells the whole story or reflects the best interest of an arm's-length buyer. Let's take a look at a real-world buyer-side engagement where our client was looking to purchase a small business.

### YOU MIGHT FIND THAT PRICE AND VALUE ARE NOT THE SAME THING

Our client approached us to prepare an independent valuation report for a private business<sup>3</sup> listed for sale at \$5 million. Our due diligence included a review of multiple years of financial data, speaking with the company's accountant, spending ½-day with one of the owners on location for a full site tour and detailed discussions, as well as interactions with other owner/operators within the industry. Finally, we prepared a valuation report

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<sup>1</sup> **Price** – “the monetary or other consideration asked, offered, or paid for an asset, which may be different from the value.” Source: *International Valuation Glossary – Business Valuation*; as updated February 24, 2022.

<sup>2</sup> **Fair Market Value** – “a standard of value considered to represent 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, each acting at arms-length in an open and unrestricted market, when neither is under compulsion to buy or to sell and when both have reasonable knowledge of relevant facts.” Source: *Ibid.*

<sup>3</sup> We offer actual details while still maintaining the anonymity of our client and the private business valued.





that considered the business on the basis of an arms-length transaction, consistent with the notion of *fair market value*.

Our analysis indicated a *fair market value* of between \$2.3 million to \$2.4 million. There are many reasons why asking *price* may not equal *fair market value* including:

- differences in the assessment of free cash flow or business risk;
- differences in value to a current owner compared to an arm's length buyer (non-transferable value attributable to key-person/current owner);
- differences in the amount of up-front capital expenditures or increased working capital a buyer may consider necessary;
- differences in motivations, financial means, or perceived synergies across various arm's-length buyers;
- different assessments of legal, regulatory, or environmental matters as well as non-operating or redundant assets owned within the business.

It may come as no surprise that, in this particular case, our client did not pursue the deal. However, what may come as a surprise is that about 10 months later, the listing agent reached out to say the seller lowered their asking price to \$2.5 million. Unfortunately, by that time, our client had already purchased a different business.

#### CLOSING THOUGHTS

We realize *fair market value* is time-dependent and acknowledge that, over the course of 10 months, much could have changed for the private business mentioned above. We also realize that the significant difference in *price* and *fair market value* in this particular example may not be typical. However, this case underscores the point we wish to make.

For anyone considering buying a private business, it can be a great benefit to engage an independent valuator as part of your due-diligence and to do so prior to making an offer. Because sometimes this one extra step could save you millions.

Thank you,

D. J. Myles Martin, CFA, CVA, CBV, FMVA  
Business Valuator and Founder  
Myles Martin & Company Inc.  
[www.mylesmartin.ca](http://www.mylesmartin.ca)  
[djmm@mylesmartin.ca](mailto:djmm@mylesmartin.ca)  
(289) 776-8615



(289) 776-8615  
[djmm@mylesmartin.ca](mailto:djmm@mylesmartin.ca)  
[www.mylesmartin.ca](http://www.mylesmartin.ca)



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