



HILL, BARTH & KING LLC  
BUSINESS VALUATION GROUP COMMUNICATION

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## **Financial versus Strategic Buyers within the Contexts of Fair Market Value and Sale of a Business**

The terms *Financial Buyer* and *Strategic Buyer* frequently arise in discussions about Business Valuations, particularly with respect to the Fair Market Value standard. In addition, the terms are commonly used when discussing the sale of a business. The HBK Business Valuation Group prepared this article to elaborate on the significance of financial versus strategic buyers in the valuation context, and describe some of the characteristics of each type of buyer. The article ends with some examples of circumstances that involve financial and strategic buyers.

### **The Valuation Context**

The appropriate Standard of Value for the valuation of a closely held business affects the analyses and conclusions of the valuator, and the standard of value implies a certain type of buyer. For example, *Fair Market Value* is the required standard of value in all Federal tax valuations, including gift, estate and ESOP appraisals. An important assumption in Fair Market Value appraisals is the inclusion of *hypothetical financial buyers* (described below) and the exclusion of *specific strategic buyers* (see below) when analyzing a market transaction. The *Investment Value* of the same private company, which exceeds Fair Market Value, implies a unique, and perhaps real, strategic buyer seeking control and willing to pay a premium price. The financial buyer is not willing to pay, and perhaps not capable of paying, the premium price.

Consideration of the value drivers of a strategic buyer (as described below) implies Investment Value, not Fair Market Value. A bona fide, arm's-length purchase offer from a strategic buyer indicates Investment Value at a higher level than Fair Market Value. An individual, real world purchase offer may be, but is not necessarily, an indication of Fair Market Value. The IRS guidelines state specifically that the goals of real buyers and sellers are irrelevant for purposes of determining Fair Market Value. The exclusion is due in part to remove the strategic value factors from the estimation of Fair Market Value.

A private company with strong earnings or valuable processes may have a higher Investment Value in the eyes of a motivated strategic buyer willing to pay a premium price for control and synergistic benefits. If, however, the appropriate Standard of Value is Fair Market Value, as in the case of an Employee Stock Ownership Plan transfer, Investment Value created by the expertise or motivations of strategic buyers is excluded from consideration by the valuator. In summary, financial buyers and strategic buyers exist and make deals in the real world; and their characteristics and motivations also exist in the conceptual framework of a Fair Market Value business valuation.

## **Financial Buyers**

Financial buyers in the real world are individuals or companies seeking investment opportunities over a broad range of businesses or industries. They do not possess extraordinary industry expertise or management capabilities; and may be passive investors requiring the managerial skills and expertise that are present in the target-company. Financial buyers lack unique attributes or other business capacity expected to increase shareholder value in the target-company. They are not devoid of any business strategy: they may consider industries with barriers to entry or companies of a certain size. But generally the financial buyers are interested in the target's future cash flow returns and the sale-of-business opportunities as these are estimated at the present time. They must look for well-managed companies with a proven earnings track record and outlooks for growth. They rely heavily on due diligence and scrutinize historical financial statements. They may foresee revenue and earnings growth, and profit enhancements through cost reductions, but financial buyers are not willing to pay for potential or for what the company has not already produced up to the present time. Transactions involving financial buyers tend to be highly leveraged to take advantage of the lower cost of debt (i.e., lower than the cost of equity).

## **Strategic Buyers**

Strategic buyers are characterized by, among other factors, expertise, business capacity or market position that merit consideration of the target's business fit into the buyer's broader business plans. Strategic buyers are often willing to pay a premium for the target, and this is often more than the Fair Market Value price offered by the financial buyer. The strategic buyer's goals may include vertical integration to be closer to the supply chain or customer, horizontal development into new markets or processes, or reorganization of the target's activities.

Strategic buyers expect to realize immediate synergistic benefits due to economies of scale resulting from combined purchasing power and the elimination of duplicate functions. The greater the potential synergies, the more the strategic buyer desires the target, and is willing to pay more for it. Strategic buyers are often larger, stronger companies with financial capabilities and proven methods. A strategic advantage available to some buyers is the use of stock in the offering to the target.

Contrary to the financial buyer, the strategic buyer foresees short-term enhancements to the buyer's and the target's operations as a result of combination. They bet on what are perceived as realizable synergies, and, perhaps, speculative synergies. An attractive target and a competitive market may leverage Investment Value.

## **Sale-of-Business Circumstances and the Type of Buyer**

When considering the sale of a private company, a seller's objectives may indicate whether a financial or strategic is most appropriate. Let's consider some typical seller objectives and factors that may indicate the most desirable type of buyer.

- **The Highest Price Goal:** If the primary motivation of the private company owner selling a controlling interest is realizing the highest selling price, and, effectively, there are no other key motivational factors (such as what happens to the company or employees), searching for and seeking out strategic buyers to compete against each other in an auction process may lead to generating the highest market price.
- **High Price Modified by Other Priorities:** A private company owner selling a controlling interest often seeks a high (if not highest) price as well as other priorities to be negotiated and considered. The seller may have a “best buyer” profile; or wish to make demands of the buyer as to employee matters; or protect the use of the seller’s processes. A high price implies a strategic buyer, but the seller must be willing to make concessions on price for other priorities to work in the deal.
- **The Seller Desires to Continue Working and Wants an Employment Contract:** This common requirement probably requires a financial buyer. The financial buyer’s lack of expertise and management capacity can make the seller/manager indispensable and valuable to the buyer. Strategic buyers with expertise can eliminate top management. Financial buyers may require top management to remain in order to close the deal. And deals are being structured where part of the consideration paid is tied to an “earn-out” provision in which the seller will receive additional future consideration if agreed upon goals are achieved in the years following the sale.

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The business valuation profession is attempting to spread the word that valuation knowledge and methodologies can be powerful business planning and problem solving tools. HBK business valuation experts are using valuation techniques and resources to add value to existing client services.

The Hill, Barth & King LLC web site address is [www.hbkcpa.com](http://www.hbkcpa.com). Information about our firm and the Valuation Group is available. Our firm’s headquarters are located at 7680 Market Street, Boardman, Ohio. The telephone number is (330) 758-8613.

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Inquiries to discuss specific valuation or transaction advisory matters are welcomed. An article by Hill, Barth & King LLC describing “The Valuation Process” is available upon request.

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