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**HYDE Valuations, Inc.**

**We Value Both Real Estate and Businesses
Including Machinery & Equipment**

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# *The Value of Untapped Potential*

I recently was asked a question by another business appraiser that is quite common – so common in fact, that I have heard many versions of this question over the last thirty years or so. Here is a summary of the most recent question:

> I have a client that specializes in arranging domestic help and luxury estate staff placement. This client provides domestic help for well-known celebrities (past clients include President Reagan and President Ford). However, the Company is small (annual revenues between $300,000 and $400,000) and profits are small averaging around $30,000 per year. Based on the small profits, the value of the Company is fairly low.
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> The client needs the valuation for estate planning purposes and they want a high value. The client says the client base is very valuable. They tell me another company could easily grow this business to $2 million or more by opening more locations. The current owner has chosen to stay small and not grow the business (as they enjoy the relationship with the high net worth clientele, i.e. they have chosen quality over quantity.) How should I value this company?

Essentially, this question is asking to include what I call the “value of untapped potential.”

The value of a business, or for that matter, virtually any income producing asset, is based on the present value of anticipated future earnings. However, the anticipated future earnings used to value a business must be reasonable and tie to historical earnings. Part of the definition of fair market value refers to a knowledgeable willing buyer and a knowledgeable and willing seller. In circumstances such as the above referenced scenario, the seller would like to get paid for what is envisioned as a tremendous potential upside that might occur should a buyer of the business invest lots more money and time in opening many new offices around the country using the well established format, company name, etc. However, in my experience, a knowledgeable and willing buyer will simply not pay for anything that he or she must bring to the business, i.e. additional investment, expansion, or the like.

It is not very unusual for an appraiser to develop a forecast or use a management forecast in the appraisal process that presents higher revenue and earnings than have occurred in the past. When this occurs, it must be accompanied by a strong explanation and support – it is usually also accompanied by a much higher risk reflected in a higher than normal discount and/or capitalization rate. Should an appraiser attempt to develop an income forecast for the above scenario using multiple offices that might be created by a buyer, I believe that the valuation would become a hypothetical valuation, i.e. a valuation based on something known to be false, but assumed to be true for the purpose of the analysis. While there occasionally is a need for such an analysis, development of such an appraisal of the above scenario for a use like estate and gift planning (this use requires the application of the fair market value standard and following IRS Revenue Ruling 59-60), would, in my view, likely constitute malpractice on the appraiser’s part.

In today's real estate market, we occasionally encounter a similar problem with investors that purchased raw undeveloped land at the peak of the market and now, after holding the land for five or six years, claim that it should still be worth peak of the market prices. They often have trouble realizing or recognizing that the market value of real estate, especially raw land, is not based on what someone paid for it years ago – it is based on the criteria set forth in the following definition of market value:

> "The most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:
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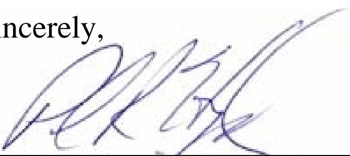
> - Buyer and seller are typically motivated.
> - Both parties are well informed or well advised, and acting in what they consider their best interests.
> - A reasonable time is allowed for exposure in the open market.
> - Payment is made in terms of cash in United States dollars or in terms of financial arrangements comparable thereto; and
> - The price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale."

Accordingly, when asked to value such a property, we search out relatively recent sales of similar property and make adjustments to account for differences. Sometimes recent sales cannot be found that are similar enough to be useful – in such cases, older sales are usually used with interviews of market participants to develop longer term indications of changes in market conditions or the area searched is widened and the adjustments become more difficult to support. No matter the circumstances, the appraiser must do whatever is necessary to develop a well supported value conclusion.

Valuations play a part in all strategic transactions, tax, and many litigation matters. For additional information or advice on a current situation, please do not hesitate to call. **We value real estate, businesses, and personal property including livestock and machinery & equipment.**

Sincerely,



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