



## Private Capital Markets Theory

We have covered the basics of business appraisal. Before we begin discussing more advanced appraisal topics, I would like to introduce you to the Private Capital Markets Theory developed by Robert T. Slee, CBA, MBA. This theory revolves around the fact that private companies behave differently than public companies. Since they behave differently, the “corporate finance” theories that explain public companies behavior does not apply. I am under the assumption that you have some knowledge of corporate finance theory and will not move into a detailed discussion. We will direct our time and attention to the Private Capital Market Theory.

The Private Capital Market Theory is based on three factors: Valuation, Capitalization, and Transfer. Each one is dependent on the other. Valuation is the foundation for the theory. However, we can not determine the value until we know which transfer method the owner elects to use. The capitalization structure relies on the value, since capital availability is determined based on level of risk and return. Transfer method may be affected by the capital structure available. The example below illustrates this relationship between the three factors.

Example: Ed is ready to retire from his rabbit farm. There are a lot of questions that will need to be answered prior to developing an exit plan. One of the questions is to whom does he want to sell the farm? If he sells the farm to the employees, as opposed to a third party, the **capital structure** of the purchase could be night and day different. Employees may not have the proper amount of cash, may not be able to borrow adequate capital from any one financial source, or may ask Ed to carry a note for a portion of the purchase price. An outside third party may have access to multiple financing options or realize synergies. The synergies, an outside party realizes, could alter the **value** of the business. Let’s assume that Ed would like to sell the business to his kids, and more importantly the kids want to purchase the business. The transaction is no longer arms length and the fair market **value** needs to be determined. With the third party buyer, we were appraising the investment or synergistic value

The Private Capital Markets Theory could not possibly be discussed in detail in one page. My goal was to introduce to you the theory’s most basic information as we go into discussions on advanced business appraisal topics. Having a basic understanding of the Private Capital Markets Theory should allow you to get more out of future appraisal education pieces. For those of you who do exit planning and mergers/acquisitions, you know how important exit planning is and how Private Capital Markets work. Those of you who do not, I encourage you to talk to your clients about doing exit planning at least three (3) years prior to selling or transferring their business. Your next question will be, how will I know when that time comes. My answer: Exactly, you do not know! The advanced planning will improve their odds of achieving their personal and financial objectives.

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