<u>PRICE VS. VALUE: KEYS TO VALUING ANY TRANSACTION</u>

In every transaction involving the sale and purchase of an asset, an agreed upon price is typically the key component in reaching a deal. Often lost in the course of negotiations is the concept of “price vs value”. While the two terms are certainly related, they have two entirely different meanings. Simply put, “price” is the figure a buyer is willing to pay for an asset; “value” is the aggregate benefit the buyer expects to receive over a period of time. You cannot agree upon a “price” without first determining the “value” of the asset. To a savvy buyer, the “price” of an asset would be far below the true “value” it would yield over time. Alternatively, a sharp seller would anticipate the intrinsic value of an asset to a specified buyer, and adjust the sale price of the asset according to a multiple of its “value”.

A classic and simple illustration of the “price vs. value” concept is demonstrated by the economics of farming. Suppose that Blackacre (que the flashbacks to 1L of law school), representing 100 acres of farm land, is listed for sale at a **<u>price</u>** of $100,000. Our prospective buyer, a soy bean farmer, believes he can generate an annual profit of $25,000 per year from farming the 100 acres of soy beans. If our farmer buys Blackacre expecting to own and farm the land for twenty (20) years, all things remaining equal, he would make a net profit of $400,000. Comparing the twenty year net “value” of the farm ($400,000) to the purchase “price” ($100,000), our farmer has made a great deal (4x his original investment), and he will enjoy his profits for years to come.

While the above illustration of “price vs. value” is overly-simplified, the task of assigning “value” can be daunting. Not every business or asset can be valued in the same manner, and many assets are much more complicated than Blackacre. After all, you would not value a young, start-up company in the same way you would an established, more mature business with fifteen years of quarterly results. Valuation metrics such as price/revenue, price/earnings, discounted cash flow, book value, and the value of a brand name or customer goodwill all factor into the valuation multiple in setting the sale price. A confident seller will set their price at a multiple of a certain metric (i.e. 3x next year’s earnings), and force you to scrutinize every metric in order to guarantee you are receiving the intended value for the price paid.

Whether you are buying or selling an asset, agreeing to a price too quickly without examining the expected value can lead to disastrous results. Overpaying for an asset can stress your bottom line and result in lost profits and reduced cash flow. While “value” can certainly be subjective from one buyer to another, if you pay a higher “price” than the “value” received, you have lost money on the deal.

A note to the reader: This article is intended to provide general information and is not intended to be a substitute for competent legal advice. Competent legal counsel should be consulted if you have questions regarding compliance with the law.

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