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BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

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Just Released: 2023 Benchmarking Guide for Family Business Directors

Unpacking the *Corporate Transparency Act*

A Lifelong Succession Plan | Lessons from the Arnault Family

Tax Court Sides with Family Business in *Cecil*

Just Released: 2023 Benchmarking Guide for Family Business Directors

Growing up playing football, the team would gather after every game to run back the tape and review film. Rewatching games where you made a big play and the team won was always a good feeling. A loss? As my college coach from East Tennessee used to say, "Katy, bar the door."

If 2021 was a comeback win for a lot of companies after the COVID-19 downturn, 2022 was like running into a stonewall defense. Rising interest rates, breakneck inflation, and the Russia-Ukraine conflict stifled offenses like the '**85 Bears.** But despite some bumps and bruises, the tape was more favorable than one might have expected. While shareholder returns were down with a broad decline in equity markets, EBITDA margins held up, albeit unevenly across industries, and total distributions (distributions and share repurchases) rose considerably over 2021. Or for a coaching cliché: "The game was really a lot closer than the scoreboard would indicate."

We are happy to share the release of our **2023 Benchmarking Guide for Family Business Directors.** Benchmarking helps provide valuable context to directors when making their most critical decisions: what should our dividend policy be, what investments should we make, and how should we finance our business? For our benchmarking report, we use the Russell 3000 Index Companies, excluding financial institutions, real estate companies, and utilities. We also exclude companies with less than $10 million in revenue in 2022. We sort the data into five quintiles based on company sizes and the following industries.

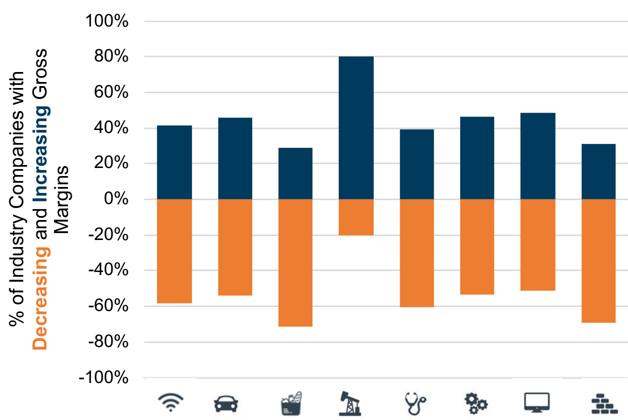
This article summarizes some of our financing, operating, investing, and distribution findings. For a comprehensive and detailed report on all the above questions, **download the full guide**.

How Much Money Do Companies Like Ours Make?

Inflation may have originally been billed as transitory and only here for a short visit, but 2022 showed us CPI is not taking the hint. The 12-month percentage change in Consumer Price Index, or CPI, has run north of 2% every month since March of 2021, with 2022 exceeding 6% the entire year. Red-hot inflation does appear to have been finally shown the door, with growth peaking in June 2022, but CPI is still well above recent historical norms and Federal Reserve targets.

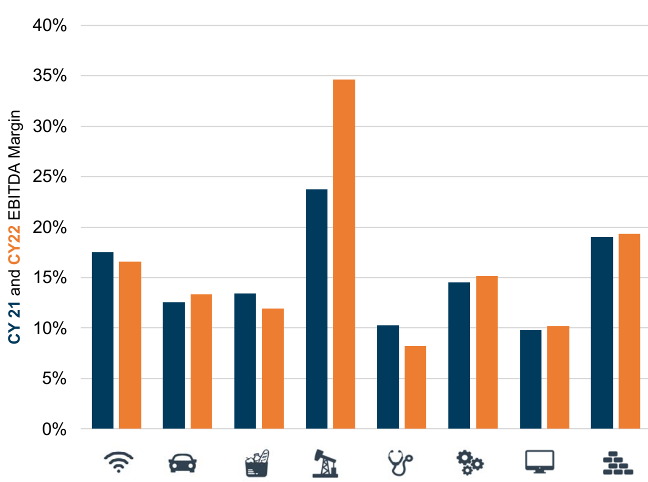
Figure 1, below, shows the number of industry constituents who saw gross margin increases and decreases in 2022 relative to 2021. Strong results in the energy sector masked gross margin challenges across other industries as companies struggled to adapt to an inflationary environment not seen since the early 1980s. The majority of energy companies saw gross margin expansion, while the majority of companies in all other industry sectors saw gross margin decline.

Figure 1 :: Gross Margin Year-Over-Year



How did costs affect the bottom line? While Wall Street often looks at earnings, EBITDA is the key earnings measure for family businesses. EBITDA serves as a proxy for discretionary cash flow available to service debt, pay taxes, fund reinvestment, and provide for shareholder distributions. Figure 2, below, highlights EBITDA margins by industry in 2022 and 2021.

Figure 2 :: EBITDA Margin Year-Over-Year



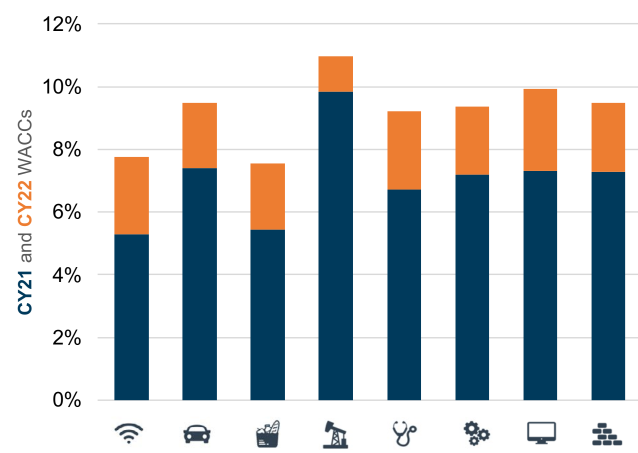
Following gross margins, EBITDA margins compressed in certain industries as pricing pressure affected industries less able to pass along price increases or reduce operating expenses. Communication services, consumer staples, and healthcare all saw year-over-year EBITDA margin declines. The energy sector saw the largest change in margin, with improving oil prices serving as a tailwind to the sector.

What Is The Hurdle Rate for Companies Like Ours?

The Fed aggressively took on the challenge of inflation. It increased rates precipitously in the middle and back half of 2022, with four 75 basis point increases between June and November of 2022. The **Fed Funds Target range** went from 0% to 0.25% in early 2022 to 4.25% to 4.50% by year-end.

The weighted average cost of capital is the blended return expectation of lenders and shareholders. We calculate the cost of each capital source and the weighted average regarding the market value of total capital. WACCs are generally higher for smaller and perceived riskier companies.

Figure 3 :: Weighted Average Cost of Capital

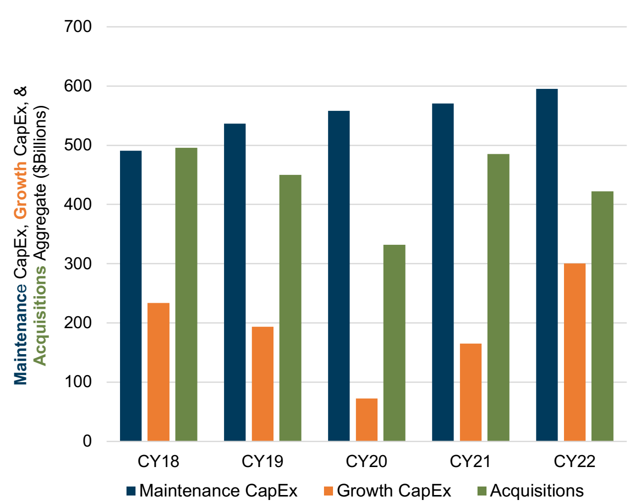


Companies use hurdle rates to help screen out potential investments. All family businesses face capital constraints, meaning they could invest in more investments than they should invest in. Along with a robust strategic review, using a hurdle rate (often the WACC) can help directors limit review of potential projects to those that are financially feasible.

As shown in Figure 3 (on the previous page), calculated WACCs in 2022 were over 2.0% higher than in 2021 on average. Increase in interest rates, with 20-Year Treasury rising from 1.94% to 4.14% from year-end 2021 to year-end 2022, the main driver. Borrowing costs (as reflected in BBB Corporate Bond Yields) were also up in line with treasuries.

What's the impact? Higher WACCs mean higher hurdle rates for companies and family businesses. This changes the calculus in reviewing potential projects and determining what is financially feasible for the business, affecting capital allocation and investment decisions. Figure 4, tracks aggregate spending on maintenance and growth capital expenditure, as well as acquisitions for the companies in the sample. Spending on acquisitions decreased in 2022 amid higher capital spending totals. Higher hurdle rates likely influenced this spending shift, as project-specific hurdle rates tied to acquisitions became perhaps less palatable to boards of directors. With more rate hikes occurring in 2023 and potentially more in the offing, 2023 could see further shifts in capital allocation decisions as we off-ramp the low/no interest rate environment.

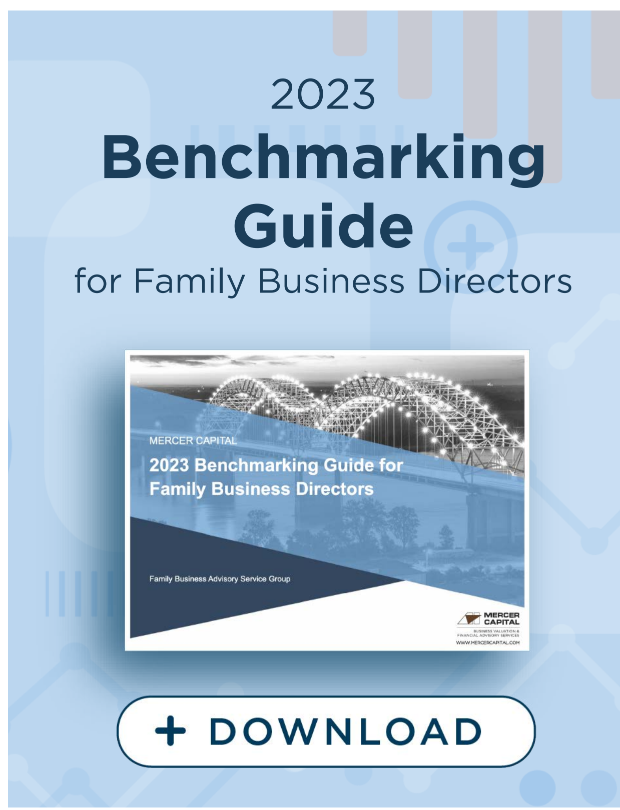
Figure 4 :: Aggregate Investment Trends



Download your complimentary copy of the **2023 Benchmarking Guide for Family Business Directors,** which gives you an in-depth analysis of the topics discussed here as well as discusses additional questions, including:

- How much money do companies like ours distribute?
- How much money do companies like ours borrow?
- How fast should companies like ours grow?
- What kind of return do companies like us generate for their shareholders?

Atticus L. Frank, CFA, ABV
(941) 244-1020 | franka@mercercapital.com



Unpacking the *Corporate Transparency Act*

On January 1, 2021, Congress enacted the *Corporate Transparency Act* (the "CTA") as part of the *Anti-Money Laundering Act* of 2020. The main purpose of the *Corporate Transparency Act* is to protect the United States financial system from being used for money laundering and other illicit activities. Effective January 1, 2024, the CTA requires a range of different entities to file a report with the U.S. Department of Treasury's Financial Crimes Enforcement Network ("FinCEN").

According to the **Reporting Rule**, FinCEN is issuing a Final Rule requiring certain entities to file reports that identify the beneficial owners of the entity and the individuals who filed an application with government authorities to create the entity or register it to do business. The prior lack of beneficial owner information ("BOI") reporting requirements made the U.S. the obvious choice to establish shell companies to ultimately hide beneficial owners and move funds.

The CTA regulations are written so broadly that nearly every family business in the U.S. will be swept under this new law. According to initial studies, the FinCEN estimates that over 32 million entities will have to file BOI reports in the first year of the Final Rule taking effect.

So, what does that mean for business owners? In this article, we answer the main questions stemming from the Final Reporting Rule of the *Corporate Transparency Act* that will most likely affect you and your family business.

Who Is Required To Report?

Any entity that is a corporation, a limited liability company ("LLC"), or a created entity filed with a Secretary of State must comply with this new reporting rule. Additionally, any entities mentioned above that are formed under the laws of a foreign country and registered to do business in any U.S. state are also subject to BOI reporting requirements. These requirements include pre-existing companies and newly formed domestic and newly registered foreign entities.

Exemptions?

There are 23 listed types of entities that are exempt from the definition of reporting company and, consequently, do not need to file reports. These include governmental authorities, banks, and accounting firms, among others. A couple corporate exemptions include:

Large operating companies that meet certain criteria, specifically, an entity that employs more than 20 full-time employees, $5 million in gross receipts or sales per filed federal tax return in the previous year, and an operating presence through a physical office in the United States.

Publicly traded companies that are issuers of securities and registered under the *Securities Exchange Act* of 1934 are also exempt.

What Information Needs to be Reported?

The Reporting Company must file each entity's business name, current address, state of formation, and Employer Identification Number ("EIN"). The Reporting Rule takes this a step further and requires the Reporting Company to identify every entity's direct or indirect beneficial owner. For beneficial owners, the information required includes full legal name, birth date, address, and government-issued ID—driver's license or passport.

The **Reporting Rule** defines a beneficial owner as an individual who meets at least one of two criteria: (1) the individual exercises substantial control over the reporting company; or (2) the individual owns or controls at least 25 percent of the ownership interests of the reporting company.

Substantial Control

There are three specific indicators that determine "substantial control" set forth by the Reporting Rule:

- Service as a senior officer of the Reporting Company—including CEO, CFO, COO, or general counsel
- Authority over the appointment or removal of any senior officer or a majority of the board of directors
- Decision-making over important matters of the Reporting Company—including reorganization, dissolution, or merger

Ownership Interest

The proposed Reporting Rule provides that ownership interests would include both equity in the company and other types of interests, such as stock, capital, or profit interests. Debt instruments will be included if they enable the holder to exercise the same rights as one of the specified types of equity or other interests. The proposed rule applies to any direct or indirect ownership interest, including through joint ownership and certain trust agreements.

When Is the Report Due?

The Reporting Rule goes into effect on January 1, 2024, and companies that exist before January 1, 2024, and meet the reporting requirements will have one year to file the required information. Entities created on or after January 1, 2024, will be required to file within 30 days of receiving notice.

Who Has Access?

The *Corporate Transparency Act* has authorized the FinCEN to disclose beneficial owner information to U.S. government agencies, certain financial institutions, as well as certain foreign agencies. The Reporting Rule states that collecting this information and providing access to law enforcement, the intelligence community, regulators, and financial institutions will diminish the ability to obscure activities through shell companies. Federal agencies will need to provide FinCEN with justified reasoning for their request, while local and state agencies will need an authorized court document to access this information.

Key Takeaways

Existing and new-forming companies will need to initially review the structures and operations of the company to determine if they are eligible for an exemption. If no exemption applies, determine who qualifies as having sufficient ownership interests that trigger the reporting requirement. And lastly, identify the members who exercise "substantial control" over the company to then comply with the beneficial owner information reporting requirements.

Due to the requirements being new, broad, and open for interpretation, there are still some unknowns to the Reporting Rule, as well as some judgment in determining who exercises substantial control over the Company.

Don't let the reporting requirements under the *Corporate Transparency Act* Reporting Rule trip up your family business. Develop a plan now to ensure that you will be in compliance.

Zac Lange

Zac L. Lange, CPA
(901) 322-9746 | langez@mercercapital.com

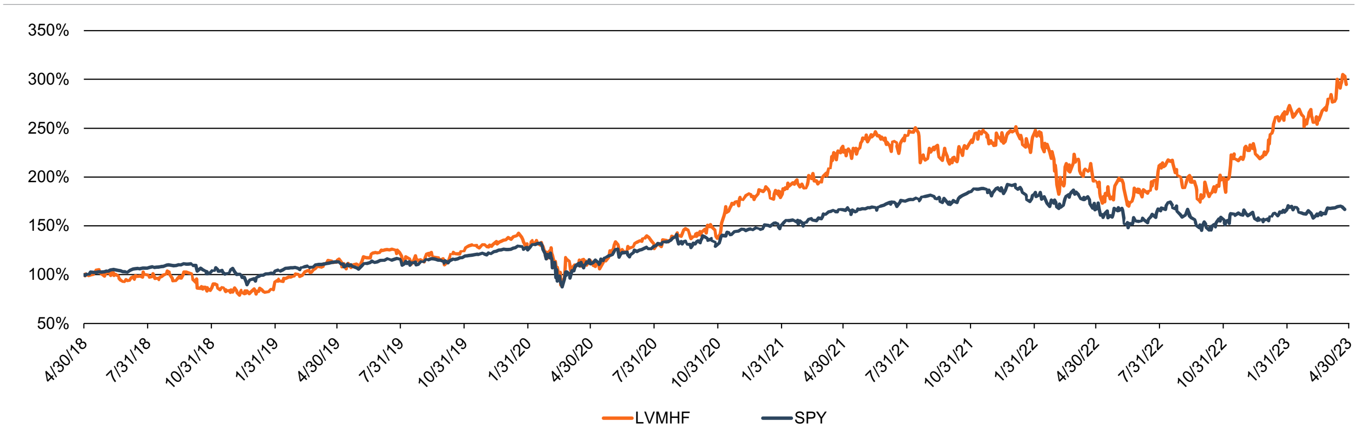
A Lifelong Succession Plan

Lessons from the Arnault Family

A recent series of **articles** from the *Wall Street Journal* has profiled the career of Bernard Arnault, founder of French luxury goods conglomerate LVMH Moët Hennessy Louis Vuitton (**LVMHF**). The company produces and sells 75 brands of high-end consumer goods covering wine, jewelry, hotels, and fashion. Mr. Arnault serves as CEO and Chairman and is the controlling shareholder. The company's stock has been on an extraordinary run since the onset of the COVID-19 pandemic in March of 2020, as affluent consumers flush with cash snatched up the company's products in the absence of other alternatives during the various pandemic lockdowns of 2020. More recently, China's loosening of COVID restrictions unleashed a massive market for luxury goods, further propelling the stock's performance. This performance has made Mr. Arnault the world's wealthiest person, overtaking tech giants Elon Musk and Jeff Bezos for this claim.

Mr. Arnault is revered worldwide for his business acumen. While nurturing generations of artists and designers within the company, Mr. Arnault has also led numerous corporate takeovers of struggling luxury brands throughout Europe and abroad, earning him the moniker "Wolf in Cashmere." Mr. Arnault's rare combination of creativity and pragmatism has built LVMH into the world's foremost purveyor of luxury goods over its 35-year history. Mr. Arnault is currently 73 and has reportedly consumed himself for decades with preserving his empire by succession. While LVMH is presently the largest company in Europe by market capitalization, Mr. Arnault has steadfastly run the company as a family business. With five children, all of whom are heavily involved in the senior leadership of several of the company's most visible brands (Dior, Tag Heuer, Vuitton), Mr. Arnault has a built-in team ready to take over LVMH once he decides its time to **retire and play tennis full-time with Roger Federer.**

Figure 1 :: LVMHF Relative Stock Performance



The most practical family business applications of Mr. Arnault's career come in his relationship with his children. While Mr. Arnault has not yet publicly named his successor nor even acknowledged if his successor will be one of his children, he and his advisers have taken careful steps over the years to ensure that the company remains under family control. Recently, Mr. Arnault restructured the family holding company that owns a 97% stake in Dior, which in turn owns roughly 47% of LVMH and over 60% of the LVMH voting rights. This restructuring gave each of his five children a 20% stake in the holding company. In addition, the agreement stipulates that the children cannot sell these interests for at least 30 years without the unanimous consent of the board and that the interests must be sold to direct descendants of Mr. Arnault (i.e., his grandchildren). The restructured commandite (the French equivalent of a limited partnership) also has a two-year rotating chairmanship, which passes among the five children.

The children have literally grown up in the business. From tagging along with Mr. Arnault to negotiations at an early age, they can quickly resolve disagreements, given their early indoctrination that the company should always come before any personal interests or conflicts. This early training, combined with world-class educations from institutions such as MIT, Imperial College London, and École Polytechnique, has paved the way for Mr. Arnault's children to ascend to their current leadership roles and created well-qualified candidates for the eventual replacement of Mr. Arnault himself. Mr. Arnault's careful (he deliberately avoids pitting the siblings against one another as rivals) but deliberate internal succession planning serves as a model to which family business owners across all industries can aspire.

Take a look at this **blog post** recapping Mercer Capital's attendance at the *Transitions 2023 Conference.* There, Travis Harms and Nick Heinz presented five questions about developing good family business owners. In the following section, we expound on these questions in the framework of Mr. Arnault's stewardship of his legacy and business through the deliberate succession planning processes he and his children have undertaken over the past several years.

How Has Your Family Encouraged Shareholders To Take A Long-Term Perspective?

Mr. Arnault and his family have taken the long-term perspective regarding their business, particularly through the recent restructuring of the holding company. However, Mr. Arnault distilled this perspective in a recent quote to the Wall Street Journal: "When you create desire, profits are a consequence." This maxim speaks to the family's dismissal of near-term results, profits, and stock performance as indicators of success. To truly create something meaningful, Mr. Arnault and his family first focus on cultivating great brands and products that will inherently generate profits, given their impact and desirability.

What Steps Does Your Family Take To Prepare Individuals To Become Shareholders?

Creating stewards of his wealth and legacy through family ownership has been one of the primary objectives of Mr. Arnault's life. From taking a personal interest in his children's educations by tutoring them himself to giving them increasingly important roles in the organization, Mr. Arnault has been preparing his children to become shareholders their entire lives.

How Much Financial Information Does Your Family Business Share With Owners? How Often?

While this question is not directly applicable to the Arnualt family, as LVMH is publicly traded and therefore subject to disclosure requirements, Mr. Arnault has repeatedly demonstrated the ability to remain focused on long-term product and brand-based goals rather than short-term financial results. He's even gone so far as to say: "You cannot dream when you talk numbers." Mr. Arnault has claimed he doesn't even look at the LVMH stock price. While we encourage family business owners to remain grounded in the financial realities of their companies, Mr. Arnault's relentless focus on long-term objectives and outcomes is something to admire.

How Does Your Family Deal With Shareholders Who Are Not Being Good Owners?

This question can be answered by examining the recently restructured Arnault family holding company. The rotating two-year chairmanship creates a level of accountability among the children, making it nearly impossible for them to be bad owners. While taking on the leadership of a multibillion dollar enterprise is not a practical mean to hold most family business owners accountable, increased responsibilities among owners can foster a spirit of accountability throughout a family ownership group. The onus of shouldering such a burden on behalf of the family business, and ultimately, the family legacy, can often be a powerful motivating force for family business owners.

How Does Your Family Solicit Input From Non-Director Shareholders?

A defining aspect of the Arnault children's upbringing in LVMH has been their relationships with the company's senior managers from outside the Arnault family. In part, Mr. Arnault's success as a manager can be attributed to the autonomy he gives managers of the 75 brands to make decisions within their realm. These managers have, in turn, imparted wisdom from their independence to the Arnault children through mentor-based relationships. This model for knowledge transfer can be applied in many family businesses. Non-family experts, whose processes and experiences are free of the bias sometimes created by family dynamics, can be valuable resources to pass on business knowledge and success to potential up-and-comers from within the family.

Bernard Arnault and his children present a unique, large-scale case of clearly defined and equitable succession planning to ensure their family business's future for generations to come.

John T. (Tripp) Crews, III
(901) 322-9735 | crewst@mercercapital.com

Tax Court Sides with Family Business in *Cecil*

In a recent decision (*Cecil v. Commissioner*, T.C. Memo. 2023-24), the Tax Court tackled the thorny issue of how to value a minority interest in an operating business with valuable underlying assets.

Although the decision does not directly address the appropriate "premise of value" in its decision, that is ultimately what the case was about. The Court's ruling was a resounding victory for the taxpayers and will likely provide critical support for future family businesses facing similar fact patterns.

Background

The *Cecil* decision addresses conflicting opinions of the fair market value of minority interests in the Biltmore Company ("TBC") during stock transfers made in November 2010. The Biltmore Company operates a hospitality business in and around the famous **Biltmore House** in Asheville, North Carolina.

The Biltmore house was built in the late 1800s by George W. Vanderbilt, and ownership of the house passed to his only child Cornelia Cecil (nee Vanderbilt), upon Mr. Vanderbilt's death in 1914. The Biltmore Company was formed as a business in 1932, owning the house and surrounding acreage, and began operating as a hospitality company.

TBC has continued to operate as a multi-generation family business since 1932. The 2010 transaction that is the subject of this decision involved the transfer of shares from Mr. William Cecil and his wife to their children and grandchildren. William Cecil is Ms. Cecil's son and Mr. Vanderbilt's grandson. At the valuation date, Mr. Cecil's children, Bill Cecil and Dini Pickering, served as CEO and vice chairman of TBC, respectively.

After offering simple tours of the house and adjoining gardens for decades, TBC adopted a long-range plan to become a "multiday destination" in 1995. At the valuation date, following the execution of this plan, the Company operated at least 17 lines of business and employed more than 1,300 individuals. In short, TBC was an operating business with a long history.

Meanwhile, the TBC shareholders engaged in a series of actions to perpetuate the business operation under family ownership.

- In June 1999, the shareholders entered into a voting trust agreement with the express purpose of "secur[ing] continuity and stability in the Company's policies and management…."
- In 2003, the Company embarked on a "Family Business Preservation Program." This program encompassed numerous activities designed to, among other things, prepare the next generation (Mr. Vanderbilt's great-great-grandchildren) to assume leadership of TBC's management.
- In December 2009, the shareholders executed a shareholders' agreement. The purposes of the agreement included providing for continued ownership and control of all issued and outstanding TBC shares. Under the agreement, share transfers were generally limited to lineal descendants of the then-current shareholders.

Key Valuation Issue

While the Tax Court's decision addresses multiple issues, including methods for tax affecting S Corporation earnings, non-voting discounts, the effect of block size on fair market value, and the magnitude of minority and marketability discounts, we discuss the primary issue of the weight assigned to different valuation indications.

There are three basic approaches to the value of a business:

- **Income approach.** Valuation methods under the income approach are oriented toward the future: what cash flows are expected to be generated by the business, and what is the present value of those cash flows today?
- **Asset-based approach.** Valuation methods under the asset-based approach are focused on the subject company's balance sheet: what assets does the business own and what are those assets worth?
- **Market approach.** Valuation methods under the market approach look to the observable behavior of other investors: based on prices paid by investors for similar businesses, what would an investor pay for this business interest?

The taxpayer retained two valuation experts to testify at trial, while the IRS hired one business valuation expert and one art appraisal expert.

TBC was profitable except for a loss during the G*reat Recession* in 2008. Each of the three business valuation experts developed indications of value for TBC under the income approach. All three experts agreed that the value of the operating business under the income approach was on the order of $15 million on a marketable minority interest basis. [1]

The taxpayer's valuation experts also applied methods under the market approach, which generally corroborated the indications derived under the income approach. However, the Court took a rather dim view of those analyses, so we will not address them here.

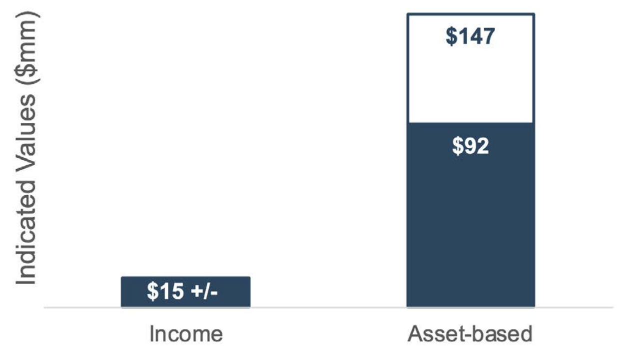
[1] The valuation expert for the IRS added the value of certain "non-operating" assets to the indicated value derived in the market approach.

[2] In this case, the fair market value of the smaller block of Class B non-voting shares. Other blocks were assigned different values for reasons beyond the scope of the present article.

The business valuation expert retained by the IRS also developed an indication of value under the asset-based approach. Relying on real estate and fine art appraisals of certain assets owned by TBC, the expert derived an indicated value of $92 million under the asset-based approach ($147 million before minority interest discount).

Figure 1 illustrates the disparity in indicated values under the income and asset-based approaches in the case.

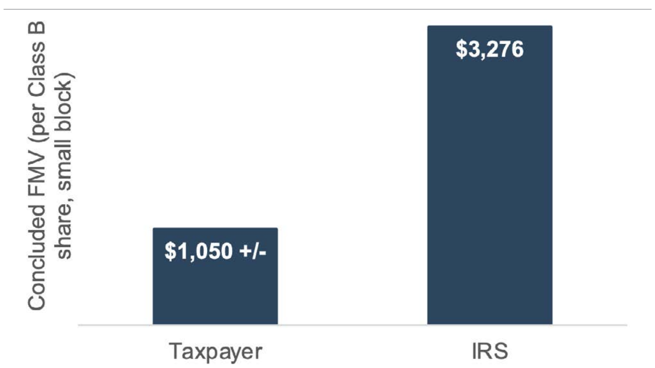
Figure 1 :: Indicated Values - Income vs. Asset Approach



This fact pattern in the *Cecil* case throws the challenge of assigning weight to various valuation methods in deriving an indication of value into stark relief.

Setting aside the other valuation questions presented by the case, the valuation experts for the taxpayer relied exclusively on the income approach to value. In contrast, the valuation expert for the IRS assigned some weight to the indicated value under the asset-based approach. Figure 2 summarizes the resulting indications of fair market value for one of the subject blocks of TBC shares.[2]

Figure 2 :: Concluded Fair Market Value



The Tax Court's Conclusion

Faced with the large disparity between the indicated values of TBC under the income and asset-based approaches, the Tax Court focused on characterizing TBC as an operating business rather than a holding company. The Tax Court concluded that, as an operating business, "TBC's earnings rather than its assets are the best measure of the subject stock's fair market value."

The Tax Court went so far as to suggest that the IRS's valuation expert's partial reliance on the asset-based approach was inconsistent with the Uniform Standards of Professional Appraisal Practice ("USPAP"), citing USPAP Standards Rule 9-3. Standards Rule 9-3 indicates that a "liquidation value" is applicable in a valuation if the subject equity interest possesses the ability to cause liquidation. The Tax Court noted that the shares transferred in this case clearly did not have that ability.

The Tax Court noted that the realization of a value approximating under the asset-based approach would occur only upon the liquidation of TBC. Fair market value reflects the perspective of a hypothetical willing buyer or seller of the shares, not that of any specific individual, such as the existing owners of TBC shares. From the perspective of a hypothetical willing buyer, the Tax Court concluded that the Company's assets would be liquidated only upon the occurrence of one of three events:

1. The hypothetical buyer acquired additional shares, which would convey to them the ability to force liquidation,
2. The hypothetical buyer convinced the other shareholders to vote for liquidation, or
3. The other TBC shareholders (or their heirs) decided to liquidate TBC.

Based on the facts in this case—the long operating history and the various actions taken by the TBC shareholders over the decade leading up to the valuation date to assure continuity of family ownership—the Tax Court concluded that the occurrence of any of these three liquidating events was unlikely.

As a result, the Tax Court declined to assign any weight to the indicated value under the asset-based approach, handing the taxpayer a clear victory.

While the decision does not specifically refer to the "premise of value," the correct premise is ultimately what the case is about. The International Glossary of Business Valuation Terms defines premise of value as "an assumption regarding the most likely set of transactional circumstances that may be applicable to the subject valuation." There are two premises of value:

- **Liquidation** – assumes the business is terminated and the assets are sold piecemeal, can be either "orderly" or "forced."
- **Going concern** – assumes the business is an ongoing enterprise expected to generate future earnings.

In *Cecil*, the Tax Court concluded that the indicated value under the asset-based approach was effectively a liquidation premise of value, which was not appropriate because the subject interest could not compel a liquidation. Rather, the fair market value of the shares was, in the Court's view, more properly determined under a going concern premise of value as manifest in the income approach.

Judicial opinions are always fact-specific, and numerous facts, in this case, proved persuasive regarding the premise of value. Those facts are specifically the long operating history of the subject business and the active efforts of the current generation of shareholders to pursue long-term continuity of ownership. Taxpayers in similar circumstances should be heartened by the Tax Court's conclusions in *Cecil*.

As the sunset provisions of the *Tax Cut and Jobs Act* of 2017 draw nearer, family shareholders will find the coming months an opportune time to advance their broader estate planning objectives. Give one of our valuation professionals a call today to discuss your valuation needs in confidence

Travis W. Harms, CFA, CPA/ABV
(901) 322-9760 | harmst@mercercapital.com

Mercer Capital

Mercer Capital's ability to understand and determine the value of a company has been the cornerstone of the firm's services and its core expertise since its founding.

Mercer Capital is a national business valuation and financial advisory firm founded in 1982. We offer a broad range of valuation services, including corporate valuation, gift, estate, and income tax valuation, buy-sell agreement valuation, financial reporting valuation, ESOP and ERISA valuation services, and litigation and expert testimony consulting. In addition, Mercer Capital assists with transaction-related needs, including M&A advisory, fairness opinions, solvency opinions, and strategic alternatives assessment.

We have provided thousands of valuation opinions for corporations of all sizes across virtually every industry vertical. Our valuation opinions are well-reasoned and thoroughly documented, providing critical support for any potential engagement. Our work has been reviewed and accepted by the major agencies of the federal government charged with regulating business transactions, as well as the largest accounting and law firms in the nation on behalf of their clients.

Contact Us

Travis W. Harms, CFA, CPA/ABV
901.322.9760
harmst@mercercapital.com

Nicholas J. Heinz, ASA
901.322.9788
heinzn@mercercapital.com

Andrew B. Frew, ASA, ABV
832.966.0345
frewa@mercercapital.com

J. David Smith, ASA, CFA
832.432.1011
smithd@mercercapital.com

Scott A. Womack, ASA, MAFF
615.345.0234
womacks@mercercapital.com

Timothy R. Lee, ASA
901.322.9740
leet@mercercapital.com

Bryce Erickson, ASA, MRICS
214.468.8400
ericksonb@mercercapital.com

Matthew R. Crow, ASA, CFA
901.322.9728
crowm@mercercapital.com

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www.mercercapital.com

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