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Supreme Court Upholds *Connelly*

Life Insurance Proceeds and Redemption Obligations in Buy-Sell Agreements

Your Family Business Will Transact: Are You Ready?

Home Depot Announces SRS Distribution Acquisition

What to Look for in a Quality of Earnings Provider



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The United States Court of Appeals, Eleventh Circuit, rendered a decision in the matter of *Estate of Blount v Commissioner of Internal Revenue* in October 2005.¹ The primary takeaway from that decision was that life insurance used as a funding vehicle to pay a company's liability to repurchase shares upon the death of a shareholder does not add to the value of the company for federal gift and estate tax purposes.

The United States Court of Appeals, Eighth Circuit, rendered a decision in the matter of *Thomas Connelly v. United States* in June 2023.² The primary takeaway from that decision is that life insurance received at the death of a shareholder is a corporate asset that adds to the value of the company for federal gift and estate tax purposes.

Given this apparent split in the decisions of the Eighth and Eleventh circuits, the Eighth circuit's case was offered to the Supreme Court of the United States on writ of certiorari. The Supreme Court of the United States ("SCOTUS") rendered its decision in the matter of *Connelly*, as *Executor of the Estate of Connelly v. United States* (602 U. S. ____ (2024), decision rendered June 6, 2024). The unanimous decision of the Supreme Court was rendered by Justice Thomas, who wrote in summary:

Michael and Thomas Connelly owned a building supply corporation. The brothers entered into an agreement to ensure that the company would stay in the family if either brother died. Under that agreement, the corporation could be required to redeem (i.e., purchase) the deceased brother's shares. To fund the possible share redemption, the corporation obtained life insurance on each brother. After Michael died, a narrow dispute arose over how to value his shares for calculating the estate tax. The central question is whether the corporation's obligation to redeem Michael's shares was a liability that decreased the value of those shares. We conclude that it was not and therefore affirm.

I am not a lawyer and am careful when analyzing cases. However, it appears that SCOTUS wrote its decision in a very narrow fashion. It did not, for example, appear to reject the Eleventh Circuit's decision in *Blount*, but affirmed the Eighth Circuit's decision in *Connelly*.

At the very least, in light of the Supreme Court's ruling, every buy-sell agreement funded by life insurance should be reviewed by competent legal and tax counsel to ensure that the agreements operate as planned when triggered.

Basic Facts of Connelly

The basic facts can be summarized as follows:

1. Michael and Thomas Connelly, brothers, were the owners of Crown C Supply ("Crown" or "the Company"), a company located in St. Louis, Missouri.
2. Michael owned 385.9 shares representing 77.18% of the shares outstanding.
3. Thomas owned 114.1 shares representing 22.82% of the shares outstanding.
4. On August 29, 2001, Michael and Thomas entered into a stock purchase agreement to ensure that Crown would stay in the family if either brother died. The agreed upon value (certificate of value) at that time was \$10,000 per share, or \$5 million. Under the agreement, the surviving brother had an option to purchase the deceased brother's shares. If a brother declined to purchase, Crown would be required to purchase the deceased brother's shares.
5. The agreement called for an appraisal process to determine the fair market value of a deceased brother's shares. Crown was to select an appraiser and the estate of a deceased brother was to select another. Both were to provide fair market value opinions. If the two appraisal conclusions were more than 10% apart, the appraisers would select a third appraiser, who would also provide an opinion of fair market value.
6. Crown obtained \$3.5 million of life insurance on each brother's life, which at some point was reduced to \$3 million.
7. Michael died on October 1, 2013.
8. At the time of Michael's death, there was no agreed upon certificate of value.
9. Thomas opted not to purchase Michael's shares, giving rise to Crown's obligation to purchase Michael's shares. *The parties did not engage in any appraisal process, as called for in their agreement.*
10. Michael's son and Thomas agreed in an "amicable and expeditious manner" that Michael's shares were worth \$3,000,000 (77.18% x \$3,860,000 = \$2,978,148) of an agreed upon value of \$3,860,000). The purchase price resulted from what was described as an extensive analysis of Crown's books and an extensive analysis of assets and liabilities of the company. Thomas, an experienced businessman extremely knowledgeable about Crown's finances, was able to ensure an accurate appraisal of the shares.³
11. Note the \$3 million purchase price for Michael's shares implied a value for 100% of Crown of \$3.86 million (\$3,000,000 / 77.18%). Recall that the certificate of value agreed upon in 2001 provided a value of \$5,000,000 for Crown, or significantly higher than the agreed upon \$3.86 million.
12. Crown collected the life insurance proceeds and purchased Michael's shares for ~\$3,000,000, and Michael's estate filed an estate tax return based on this value.
13. The IRS audited the estate's return and claimed a deficiency of \$889,914, or 38.4% of the difference between \$5,294,458 (life insurance is a corporate asset) and \$2,978,148 (life insurance is a funding vehicle).
14. Interestingly, there is no record of an appraisal conducted on behalf of the IRS. During the audit, the Company retained an accounting firm to provide an appraisal. The concluded fair market value, assuming that the obligation to repurchase Michael's stock was a real liability, was \$3.86 million.
15. Reading between the lines in the earlier decisions, it seems that the IRS was more interested in challenging the use of life insurance proceeds as a funding vehicle rather than as a corporate asset. The case leaves a big question regarding the actual fair market value of Crown on the date of Michael's death.
16. Michael's estate paid the deficiency, and Thomas, as executor, sued the United States for a refund.
17. The District Court (Eighth Circuit) granted summary judgment to the Government, holding that to accurately value Michael's shares, the \$3 million in life insurance proceeds must be counted in Crown Supply's valuation.⁴
18. The Eighth Circuit affirmed.

19. SCOTUS, in a unanimous decision written by Justice Thomas, affirmed the decision of the Eighth Circuit Court of Appeals.

Justice Thomas wrote:

The dispute in this case is narrow. All agree that, when calculating the federal estate tax, the value of a decedent's shares in a closely held corporation must reflect the corporation's fair market value. And, all agree that life insurance proceeds payable to a corporation are an asset that increases the corporation's fair market value. The only question is whether Crown's contractual obligation to redeem Michael's shares at fair market value offsets the value of life insurance proceeds committed to funding that redemption.

Whether the SCOTUS decision in *Connelly* is the death knell of entity repurchase agreements is a question. However, the decision will raise questions and should require every company with company-owned life insurance on the lives of its owners to evaluate the effectiveness of their buy-sell agreements and related life insurance.

SCOTUS Example of a Redemption

Justice Thomas wrote:

An obligation to redeem shares at fair market value does not offset the value of life insurance proceeds set aside for the redemption *because a redemption does not affect any shareholder's economic interest.* (at pp. 6-7) (emphasis added)

Following this statement, an example is provided in the text of the decision. We examine this example more visually in the analysis that follows. We call the hypothetical company in the decision "SCOTUS Example Co." The initial balance sheet and ownership of SCOTUS Example Co. are shown in Figure 1.

SCOTUS Example Co. has \$10,000,000 in cash/operating assets. Owner A holds 80% of

the stock which is worth \$8,000,000. Owner B owns 20% of the stock, which is worth \$2,000,000.

We assume that Owner B dies (and there is no life insurance) or that the Company simply redeems his 20% interest for \$2,000,000. The Company retires Owner B's shares to treasury, and now there are only 80 shares outstanding. The effect of this is to remove Owner B as a shareholder, lower the Company's value by \$2,000,000, and elevate Owner A to ownership of 100% of the shares now outstanding. The remaining \$8,000,000 value of the Company plus the \$2,000,000 in Owner B's estate amount to \$10,000,000, or exactly the value before the redemption of Owner B's shares, as seen in Figure 2 (on the next page).

Justice Thomas then concluded:

The value of the shareholders' interests after the redemption – A's 80 shares and B's \$2 million in cash – would be equal to the value of their respective interests in the corporation before the redemption. Thus, a corporation's contractual obligation to redeem shares at fair market value does not reduce the value of those shares in and of itself.

It is an incorrect conclusion to suggest that the example redemption "does not affect any shareholder's economic interest." It is true that Owner B received the \$2.0 million value of his shares in the example. Owner A's interest, while still valued at \$8.0 million as before the redemption, now represents a 100% interest in a smaller company. Owner A's economic interest has, indeed, changed. Instead of owning the right to 80% of the economic benefits of the pre-redemption company, he now owns the rights to 100% of the economic benefits of a company that is different (smaller) than before.

Figure 1

Initial Balance Sheet

SCOTUS Example Co.			
Cash/Operating Assets	\$10,000,000	\$10,000,000	Equity
Total Assets	\$10,000,000	\$10,000,000	New Equity

Assumed by SCOTUS

Initial Ownership

	Ownership	Shares	Value	Value/Share
Owner A	80.0%	80	\$8,000,000	\$100,000
Owner B	20.0%	20	\$2,000,000	\$100,000
Company	100.0%	100	\$10,000,000	\$100,000

Assumed by SCOTUS
Value per share

Figure 2

		SCOTUS Example Co.				
After Owner B's Death						
Initial	Cash/Operating Assets	\$10,000,000	\$10,000,000	Equity		
Less: Redemption	- Cash	(\$2,000,000)	(\$2,000,000)	- Equity		
New Corporate Value	Total Assets	<u>\$8,000,000</u>	<u>\$8,000,000</u>	Adjusted Equity		
Revised Ownership						
	Ownership	Shares	Value	Value/Share		
Owner A	100.0%	80	\$8,000,000	\$100,000.00		Owner A now has 100% of the stock
Owner B	-	-	-	-		
Company	100.0%	80	\$8,000,000	\$100,000.00		Owner B's value is not changed
Owner B's Estate	0	0	\$2,000,000	na		Owner B has \$2,000,000 and no stock
Cash/Operating Assets + Owner B's Redemption			\$10,000,000			

There is a significant leap from the SCOTUS example to Justice Thomas's conclusion. There is no life insurance in the example, yet it is the life insurance that is assumed to increase the value of Crown. We examine the case to understand the presumed reduction in value (or not) inferred in this conclusion.

Is Life Insurance a Corporate Asset or Is it a Funding Vehicle?

There are two opposing treatments of life insurance proceeds in valuations for purposes of buy-sell agreements. As I wrote in 2010 in a book about buy-sell agreements:⁵

Treatment 1 – Proceeds are a funding vehicle and not a corporate asset. One treatment would not consider the life insurance proceeds as a corporate asset for valuation purposes. This treatment would recognize that life insurance was purchased on the lives of shareholders for the specific purpose of funding a buy-sell agreement. Under this treatment, life insurance proceeds, if considered as an asset in valuation, would be offset by the company's liability to fund the purchase of shares. Logically, under this treatment, the expense of life insurance premiums on a deceased shareholder would be added back to income as a nonrecurring expense.

Treatment 2 – Proceeds are a corporate asset. Another treatment would consider the life insurance proceeds as a corporate asset for valuation purposes. In the valuation, the proceeds would be treated as a nonoperating asset of the company. This asset, together with all other net assets of the business, would be available to fund the

purchase of shares of a deceased shareholder. Again, under this treatment, the expense of life insurance premiums on a deceased shareholder would be added back to income as a nonrecurring expense.

The Internal Revenue Service in *Connelly* treated the life insurance proceeds as a corporate asset to be added to value in the determination of fair market value. This is Treatment 2 above. Michael's estate argued that the life insurance proceeds should be treated as a funding vehicle to finance the redemption of a shareholder's shares upon his death, which is Treatment 1 above (and, effectively, the conclusion in *Blount*).

SCOTUS Treatment of Life Insurance Proceeds

Using the same T-account analysis as with the discussion of SCOTUS Example Co. and a simple redemption, we now look at the effective treatment employed by the Internal Revenue Service and SCOTUS.

Accept as given that Crown had an operating value of \$3.86 million (per the opinion), which is shown in the market value balance sheet at the top of Figure 3 (on the next page). Michael owned 77.18% with a value of \$2,979,148 and Thomas owned 22.82% with a value of \$880,852. These values represent their respective shares of the \$3,860,000 of operating value.

Now we examine the balance sheet after Michael's death. The life insurance of \$3,000,000 (receivable) is added to the balance sheet as an asset and as equity, raising the total value of the Company to \$6.86 million. Michael's shares

Figure 3

Crown C Supply Owns a \$3,000,000 Life Insurance Policy on Michael and Thomas

Market Value Balance Sheet

		Crown C Supply		
Given per Case	Operating Value	\$3,860,000.00	\$3,860,000.00	Equity
Company Value	Total Assets	<u>\$3,860,000.00</u>	<u>\$3,860,000.00</u>	Shareholders' Equity

Before Death of Michael Connelly

	Ownership	Shares	FMV	Value/Share	
Michael	77.18%	385.90	\$2,979,148	\$7,720	Total of 500 shares per case
Thomas	22.82%	114.10	\$880,852	\$7,720	
Company	100.00%	500.00	\$3,860,000	\$7,720	

Michael Dies and Crown C Supply Collects \$3,000,000 in Life Insurance Proceeds

Balance Sheet After Death of Michael

		Crown C Supply		
Initial	Operating Value	\$3,860,000	\$3,860,000	Equity
Life Insurance Receivable	+ Cash	\$3,000,000	\$3,000,000	+ Cash
New Corporate Value	Total Assets	<u>\$6,860,000</u>	<u>\$6,860,000</u>	Adjusted Equity

Moment After Michael's Death

	Ownership	Shares	FMV	Value/Share
Michael	77.18%	385.90	\$5,294,548.00	\$13,720
Thomas	22.82%	114.10	\$1,565,452.00	\$13,720
Company	100.00%	500.00	\$6,860,000.00	\$13,720

were worth \$5,294,548 and Thomas's shares were worth \$1,565,452. In both cases, their values per share had risen from \$7,720 per share to \$13,720 per share, or \$6,000 per share (\$3,000,000 of life insurance divided by 500 shares outstanding).

In the "Syllabus" released with SCOTUS's *Connelly* decision, we see the root of the confusion.⁶

Thomas's argument that the redemption obligation was a liability also cannot be reconciled with the basic mechanics of a stock redemption. He argues that Crown was worth \$3.86 million before the redemption, and thus, that Michael's shares were worth approximately \$3 million (\$3.86 million x 0.7718). But he also argues that Crown was worth \$3.86 million after Michael's shares were redeemed. See Reply Brief 6. Both cannot be right. A corporation that pays out \$3 million to redeem shares should be worth less than before the redemption.

Finally, Thomas asserts that affirming the decision below will make succession planning more difficult for closely held corporations. But the result here is simply a consequence of how the Connelly brothers chose to structure their agreement. (Pp. 5-9)

The implicit assumption behind this reasoning is that the value of Crown was \$6.86 million before the redemption. However, the fair market value of Crown was \$3.86 million before Michael's death. We finish the example in Figure 4.

The problem is that Crown was not worth \$6.86 million until the moment after Michael's death. However, it was only after his death that the life insurance receivable, which was a contingent asset, available to Crown came into being. And after his death, the contingent liability to redeem his shares was also triggered.

In Figure 4 (on the next page), the redemption, given the new value of \$6.86 million, did reduce the value of Crown by \$5,298,548, or Michael's share of that value. Thomas, on the other hand, experienced an increase in value from before Michael's death (\$880,852, or \$7,720 per share) to the post-redemption value of \$1,565,452, or \$13,720 per share. His value increased because he benefited from his 22.82% of the life insurance proceeds (22.82% x \$3,000,000) of \$684,600. When this is added to his original value of \$880,852, his post redemption value is \$1,565,452, and his ownership rose from 22.18% to 100% because of the redemption of Michael's shares.⁷

Figure 4

Moment After Redemption of Michael's Estate

Balance Sheet After Michael's Death		Crown C Supply			
Initial	Operating Value	\$3,860,000	\$3,860,000	Equity	
Life Insurance Receivable/Proceeds	+ Cash	\$3,000,000	\$3,000,000	+ Cash	
Redemption of Thomas' Estate	- Redemption	(\$5,294,548)	(\$5,294,548)	- Equity	
New Corporate Value	Total Assets	\$1,565,452	\$1,565,452	Adjusted Equity	
Post-Redemption of Michael		Ownership	Shares	FMV	Value/Share
Michael	0.0%	0.00	\$0.00	na	
Thomas	100.0%	114.10	\$1,565,452	\$13,720	
Company	100.0%	114.10	\$1,565,452	\$13,720	
Michael's Estate	0%	0.00	\$5,294,548	na	
Total of Michael's Estate plus Remaining FMV			\$6,860,000		

SCOTUS treated the life insurance on Michael's life as a corporate asset and essentially assumed that this asset was available to the shareholders, while ignoring the contingent liability that Crown had to redeem Michael's shares.

Presumably, Crown would have to use existing assets of \$2.3 million (or borrow funds) to achieve the redemption. This would leave the Company in an undercapitalized state post-redemption with only \$1.565 million of capital because the life insurance proceeds were included in the value of the Company. This is precisely the situation that the life insurance proceeds were supposed to have precluded.

Michael's Estate Treated Life Insurance as a Funding Vehicle

For clarity, we repeat the initial position of Crown before Michael's death in Figure 5.

Crown was stated to have a fair market value of \$3.86 million, divided between the shareholders as discussed previously and shown in Figure 5. Upon Michael's death, the life insurance policy was triggered, and Crown had a receivable and then proceeds of \$3.0 million.

Figure 5

Example Company Owns a \$3,000,000 Life Insurance Policy on Michael Connelly and a Corresponding Liability to Repurchase His Shares at his Death Based on Agreement of the Owners of Example Company

Market Value Balance Sheet Before Death of Michael		Crown C Supply			
	Operating Value	\$3,860,000	\$3,860,000	Equity	
Company Value	Total Assets	\$3,860,000	\$3,860,000	Shareholders' Equity	
Before Death of Michael Connelly		Ownership	Shares	Value	Value/Share
Michael	77.18%	385.90	\$2,979,148	\$7,720	
Thomas	22.82%	114.10	\$880,852	\$7,720	
Company	100.00%	500.00	\$3,860,000	\$7,720	Initial value

Note: The case says \$3,000,000 of life insurance was used to redeem Michael's shares. The actual value was \$2,979,148 (77.18% x \$3,860,000). We are ignoring the \$20,852 difference for simplicity

Figure 6

**Michael dies and Crown C Supply collects \$3,000,000 in life insurance proceeds.
Crown C Supply redeems Michael's shares for \$7720 per share, or \$2,979,148.
This occurs, effectively, off the balance sheet.**

		Cash In	Cash Out	
Life insurance proceeds in and out	Crown C Supply	\$3,000,000	(\$2,979,148)	
	Remaining Benefit	\$20,852		(ignoring for simplicity)
Crown C Supply redeems Michael's 385.9 shares	Michael's Estate	\$2,979,148		

Simultaneously, Crown's contingent liability to redeem Michael's shares was triggered. What happens, essentially, happens off-balance sheet, as seen in Figure 6.

At this point, we see that both the contingent asset (life insurance proceeds) and the contingent liability (to purchase Michael's shares) are used to offset each other. This is how well-written buy-sell agreements have operated for many years. There is most often an appraisal process to determine fair market value, but this was ignored by Michael's estate and Thomas.

Crown received \$3.0 million of proceeds and paid out \$3.0 million to satisfy the matching liability.

We now examine the impact of these off-balance sheet transactions on Crown, Michael's estate, and Thomas, as the remaining owner, in Figure 7.

Reading the Eighth Circuit's opinion on *Connelly* and now the SCOTUS opinion, the judges and justices seemed to

think there was some skulduggery on the part of Crown and Michael's estate. There was not. What the parties were guilty of was not following their own procedures. They did not have a certificate of value to establish the price for Michael's redemption, as their agreements called for.

Then, when Thomas did not purchase Michael's shares, the parties did not follow the valuation process called for in their buy-sell agreement. They cobbled together a non-independent valuation.

Had Thomas, Crown, and Michael's estate followed their own planning, the overall result could have been significantly different.

A part of the quotation above from the "Syllabus" to the SCOTUS opinion is repeated for emphasis.

Thomas's argument that the redemption obligation was a liability also cannot be reconciled with the basic mechanics of a stock redemption. **He argues that Crown**

Figure 7

Balance Sheet After Redemption	Crown C Supply				
	Operating Value	Value	Equity		
Initial	\$3,860,000	\$3,860,000	Equity		
Interim Corporate Value	Total Assets	\$3,860,000	\$3,860,000	Adjusted Equity	
After Redemption	Ownership	Shares	Value	Value/Share	
Michael	-	0.00	-	na	
Thomas	100.0%	114.10	\$3,860,000	\$33,830	
Company	100.0%	114.10	\$3,860,000	\$33,830	Reduced share count
Michael's Estate	0	0	\$2,979,148	na	Increase in value per share Value of entity is unchanged
Crown C Supply Value Plus Michael's Estate's Redemption			\$6,839,148		
Rounding			\$20,852		
Crown C Supply Value Plus Michael's Estate's Redemption			\$6,860,000		

was worth \$3.86 million before the redemption, and thus, that Michael's shares were worth approximately \$3 million (\$3.86 million x 0.7718). But he also argues that Crown was worth \$3.86 million after Michael's shares were redeemed. See Reply Brief 6. Both cannot be right. A corporation that pays out \$3 million to redeem shares should be worth less than before the redemption. (bold emphasis added)

As shown here previously, Crown could, in fact, be worth \$3.86 million *before* the redemption of Michael's shares for \$3.0 million and *after* the redemption, as well. Crown received \$3.0 million in life insurance proceeds (the contingent asset) that were used to satisfy the redemption of Michael's shares (the contingent liability).

There is a similar analysis of the two treatments of life insurance for buy-sell agreements in *Buy-Sell Agreements for Closely Held and Family Business Owners*.⁹

Closing Observations

The estate planning world is keenly focused on the SCOTUS decision in *Connelly*. Does the decision render entity-purchased life insurance useless, or at least, less useful than before? In the short time since the decision was rendered, much has been written and said about the impact of the decision.

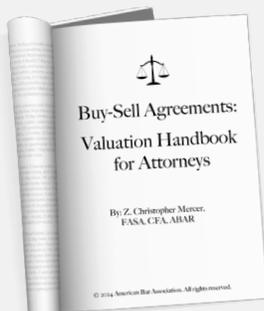
Readers of this article will need to examine that literature in the context of future planning for buy-sell agreements and for the reexamination of existing agreements. It is too soon to tell the ultimate impact of this important decision.



Z. Christopher Mercer, FASA, CFA, ABAR
901.685.2120 | mercerc@mercercapital.com

ENDNOTES

- 1 *Estate of Blount v. Commissioner of Internal Revenue Service (2005)*, United States Court of Appeals, Eleventh Circuit, No. 04-15013, October 31, 2005.
- 2 *Connelly, as Executor of the Estate of Connelly v. United States*, No. 21-3683 (8th Cir. 2023), decision rendered June 2, 2023.
- 3 *Connelly v. United States*, Memorandum and Order, page 21, September 2021. It is clear from all the decisions that no court considered Thomas to be a business appraiser, regardless of his "experience."
- 4 *Connelly, as Executor of the Estate of Connelly v. United States*, No. 21-3683 (8th Cir. 2023), decision rendered June 2, 2023.
- 5 Mercer, Z. Christopher Mercer, *Buy-Sell Agreements for Closely Held and Family Business Owners* (Memphis, Peabody Publishing, LLC, 2010)
- 6 *Connelly v. United States*, No. 23-146, *Syllabus at 2-3* (U.S. June 6, 2024). https://www.supremecourt.gov/opinions/23pdf/23-146_i42j.pdf.
- 7 Given the timing of things, Crown turned out better off than the example. Crown received \$3.0 million in life insurance proceeds and paid \$3.0 million for Michael's stock. The net worth of the Company after the redemption was \$3.86 million. Recall that Michael's estate paid \$0.9 million in estate taxes. It would appear that Michael's estate received \$3.0 million for his shares of Crown. The estate also paid the additional interest demanded by the Internal Revenue Service. That tax was \$889,914. The net effect is that Michael's estate paid taxes on \$5,294,548 of value, received \$3.0 million for his shares, and had net assets after tax of \$2.1 million. The net result is that Crown retained the \$2.3 million of extra consideration that the case says it should have paid, leaving the Company with a net worth of \$3.86 million (\$1.565 million + \$2.295 million). The real loser in all this was Michael's estate.
- 8 *Ibid*, Chapter 15.



COMING THIS FALL!

NEW BOOK PUBLISHED BY THE AMERICAN BAR ASSOCIATION

Buy-Sell Agreements Valuation Handbook for Attorneys

Z. Christopher Mercer, FASA, CFA, ABAR

The publication date is not currently set. However, check our website for the latest information. | www.mercercapital.com



Your Family Business Will Transact: Are You Ready?

Approximately 75% of business owners regret selling their business within the first year following the sale, according to a **new report**. Why? The emotions of running and owning a family business are complex, and disentangling your identity from the business can be challenging. However, we suspect some of the heartache comes down to poor planning, the feeling of leaving money on the table, and a hurried transition process.

So, have you checked in on your succession plan? Do you have a living document you discuss and update with your family board? Or does it live inside your head? In previous posts, we've offered **case studies** on family empires that have successfully transitioned from one generation to the next. But how does your business's succession and exit plan stack up?

The **2023 National State of Owner Readiness Report** issued by the Exit Planning Institute is a helpful summary of how other family businesses are handling succession and exit planning. The report asks questions such as:

- Do we have a formal succession plan?
- How do we want to exit the business?
- Have we obtained a formal valuation?
- Do we have a transition team?

Who Does the Survey Cover?

The **2023 National State of Owner Readiness Report** survey includes responses from a variety of family-run and privately

held companies. Companies surveyed come from across the country and owner-generation cohorts. Approximately 35% of companies reported revenues below \$5 million, 36% between \$5 million and \$50 million, and 29% over \$50 million. Companies also operated in diverse industries, with top respondents including construction, finance and insurance, professional services, and manufacturing. Finally, 68% of companies were 100% family-owned.

Let's Keep It in the Family

According to the survey, 70% of business owners understand all of their potential exit options and prefer an internal transition (compared to an outside sale). Of the group preferring an internal sale, family transition was the top choice among respondents. Whether you want to keep it in the family or are exploring an outside buyer, understanding the likely buyers of your business (and reasonable exit values) can help you and your family board understand the pros and cons of any exit scenario and ownership transition.

Do We Know What Our Business Is Truly Worth?

The survey sought feedback from respondents on steps businesses had taken on their business transition plans. According to the survey, 60% of business owners indicated they had obtained a formal business valuation within the last two years. However, the majority of these valuations were not for transaction or exit planning scenarios. 43% of respondents reported acquiring valuations for estate planning and

tax purposes, while only 15% sought a valuation for transaction purposes. Business owners should be aware the “purpose” of their valuation can have a big impact ultimately on the range of estimated value outcomes. Valuations for estate planning and gift tax purposes generally exclude strategic buyer considerations, relying on a non-specific “hypothetical buyer” of the business interest subject to the appraisal. Acquiring an appraisal to explore a sale could provide a better picture of your potential exit proceeds, allowing you and your family to make a more informed exit planning decision.

Is My Business Ready for Sale?

Family businesses want to know what their business is worth today. But before you think about your exit, another question to ask is what you can do today to make your family business more valuable tomorrow. The *2023 National State of Owner Readiness Report* discusses multiple actions business owners can take to be ready for an exit, as well as how respondents in the survey fared. In general, around 50% to 60% of respondents were taking steps identified as best practices. These actions included having a formal exit plan

and education, understanding their buy-sell agreements, regularly tracking their business's value, and assembling an informal team of exit planning advisors.

To state the obvious, if 50% to 60% are following best practices, that leaves almost half who are not. The best practices outlined in the survey align well with a **framework** developed many years ago by the founder of our firm, **Chris Mercer**. This framework was rooted in Chris's realization that if your business is not ready for sale when opportunities arise, you will miss out on significant potential benefits upon your exit, including exit value and overall satisfaction. To read more on this, check out Chris' book *Unlocking Private Company Wealth*.

Every family business will experience transition through internal or familial succession, a public offering, or an outside buyer. While you can't plan for every contingency, there are certain steps you can take to ensure you have as smooth and positive an outcome as possible. Mercer Capital has worked with thousands of family businesses across the country over the past forty years. Give one of our professionals a call to be part of your exit and succession planning team.

MERCER CAPITAL

Transaction Advisory Services

In addition to our corporate valuation services, Mercer Capital provides investment banking and transaction advisory services to a broad range of public and private companies and financial institutions.

- M&A Representation
- ESOP Installation, Termination, and Transactions
- Squeeze-Out Transactions
- Fairness and Solvency Opinions
- Minority Shareholder Stock Repurchases
- Corporate or Partnership Recapitalizations



Nicholas J. Heinz, ASA

901.685.2120
heinzn@mercercapital.com



Timothy R. Lee, ASA

901.322.9740
leet@mercercapital.com



Jeff K. Davis, CFA

615.345.0350
jeffdavis@mercercapital.com

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MERCER CAPITAL'S

Recent Transactions



**Specialty Construction
Materials Dealer /
Distributor**

Mercer Capital served as financial advisor to the seller in connection with an \$81 million transaction

- May 2024 -



**The Neverleak
Company LP**
ROOF FLASHINGS SINCE 1943
Olive Branch, MS

sold the majority of its assets to



NPG
NORTH PARK GROUP
Chicago, IL

Mercer Capital served as financial advisor to The Neverleak Company LP

- April 2024 -



HOSE
of South Texas, Inc.
www.hose-etc.com
Corpus Christi, Texas

has formed a partnership with



TIPCO
TECHNOLOGIES
Focused Flexible Solutions
Owings Mills, Maryland

Mercer Capital served as financial advisor to Hose of South Texas

- April 2024 -



Levo
Credit Union
Sioux Falls, SD

has announced its intent to acquire a bank branch in Sioux City, Iowa from



HERITAGE BANK
Employee Owned
Spicer, MN

Mercer Capital served as financial advisor to Levo

- April 2024 -



WORLDWIDE
ELECTRIC CORPORATION
ROCHESTER, NY

has acquired



NA
North American Electric
Hernando, MS

Mercer Capital served as the financial advisor to North American Electric

- January 2024 -



advia
credit union
Kalamazoo, Michigan

has agreed to acquire



NorthSide
Community Bank
Gurnee, Illinois

Mercer Capital served as financial advisor to Advia Credit Union

- January 2024 -

Mercer Capital provides investment banking, transaction advisory, and restructuring services to a broad range of public and private companies and financial institutions.

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Home Depot Announces SRS Distribution Acquisition

An M&A Case Study

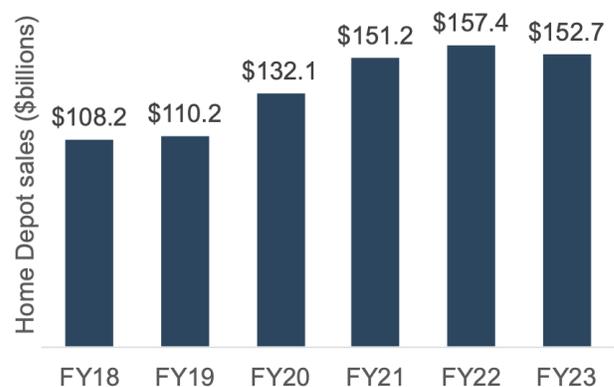
The Fed's efforts to rein in inflation from early 2022 through the middle of 2023 also reined in middle market M&A activity. Middle market transaction data provider GF Data reported data on 269 sub-\$500 million acquisitions by private equity firms in 2023, compared to 464 such deals in 2021 (a 42% decrease). Some of those "missing" deals may never happen, but we suspect most were simply deferred, leading to more robust transaction volumes as buyers and sellers acclimate to the new "normal" interest rate environment.

Home Depot's recent announcement that it was acquiring roofing and construction material distributor SRS Distribution may signal the return of more robust deal activity. Even if your family business has nothing to do with construction materials, there is plenty to note in this deal.

Home Depot :: M&A in Service of Strategy

The pandemic was good for Home Depot. Being at home under "shelter in place" opened many eyes to all the shortcomings of their shelter that a trip to the Home Depot could remedy. As a result, Home Depot's sales grew from \$110 billion in FY19 to \$132 billion in FY20 (+20%). Inflation-fueled growth in average ticket amounts kept the party going in FY21 (\$151 billion, +14%) despite a flat overall transaction count. Consumer fatigue set in during FY22, with transaction count falling by 5.4% but continuing inflationary pres-

ures supporting revenue growth of 4.1%. Amid subdued inflation and continued contraction in transaction counts, revenue decreased 3.0% in FY23.



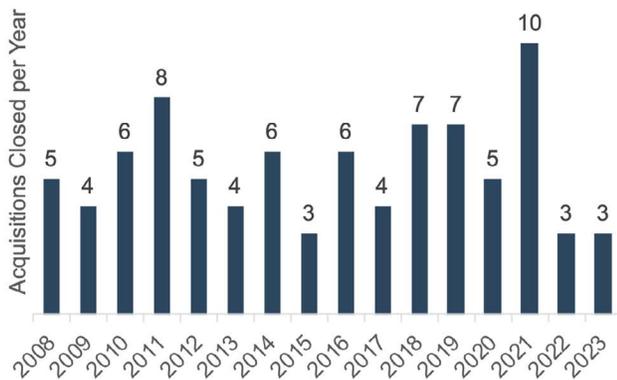
So, where to find momentum? With market share gains in the mature consumer market likely hard to deliver, Home Depot has locked onto the "Pro" market as its growth engine. The Company allocated 328 words to describe their "Pro" customers in the FY23 annual report, compared to 190 words in the FY20 annual report. Following Home Depot's \$8.7 billion December 2020 (re)purchase of HD Supply, the \$18.3 billion acquisition of SRS Distribution continues the Company's strategic push into the "Pro" market.

Home Depot's press release for the SRS deal does not emphasize synergies but rather foregrounds the growth in the company's total addressable market from the deal. At a reported multiple of 16.1x adjusted EBITDA, the transaction is not an easy value-add for Home Depot, which is currently trading at ~17x adjusted EBITDA.

Investor response to the acquisition was tepid, with HD shares shedding 1.7% during the week following the deal announcement. Time will tell if the "Pro" strategy will pay off for Home Depot, but using M&A allows the company to bring that strategy to scale much faster than an organic approach would.

SRS Distribution :: The Private Equity Playbook

From its founding in 2008, SRS has grown to a 760-branch network with annual revenue exceeding \$10 billion. How? Through an aggressive M&A strategy. As detailed on [SRS's website](#), the company has closed at least three, and up to ten, acquisitions each year since 2008.



That level of M&A activity requires a committed capital partner. SRS has had three over its history:

- **AEA Investors. AEA Investors capitalized SRS in 2008.** After concluding that roofing materials distribution was an attractive sector ripe for a consolidation strategy, AEA Investors recruited an experienced industry executive (Ron Ross) to evaluate potential "platform" acquisition

candidates. They eventually settled on Suncoast Roofers Supply, which had seven branch locations in Florida. That acquisition was followed by twenty-seven more acquisitions prior to AEA's exit in 2013, building SRS to approximately \$650 million of annual revenue.

- **Berkshire Partners. Berkshire Partners acquired SRS** from AEA Investors in February 2013. The change in ownership did not portend a change in acquisition philosophy, however. Under Berkshire's stewardship, SRS completed another twenty-six acquisitions through April 2018, growing the company's branch network to more than 200 locations and sales of approximately \$2.3 billion.
- **Leonard Green & Partners.** In June 2018, buyout firm **Leonard Green & Partners acquired** a controlling stake in SRS at an implied enterprise value in excess of \$3 billion. Berkshire Partners retained a minority stake in SRS following the transaction. Acquisitions continued apace, with over 30 additional deals completed through the end of 2023.

The SRS Distribution story is straight from the textbook private equity playbook. Four of the primary components of that playbook include:

- **Partner with and incentivize a high-quality, experienced management team.** Private equity firms typically use equity compensation to ensure portfolio company management teams are economically aligned with the PE investor.
- **Scale the business quickly through acquisitions and optimize operating margins by taking advantage of that scale in purchasing and back office functions.** Home Depot's press release announcing the transaction indicates that SRS generates an adjusted EBITDA margin on the order of 11%, consistent with that of large, publicly traded industrial distributors.
- **Use other people's money (i.e., debt).** SRS started in the depths of the Great Recession and has enjoyed historically low borrowing costs throughout its history.

- **Take advantage of multiple arbitrage.** Bigger companies generally get bigger deal multiples. Home Depot is paying 16.1x adjusted EBITDA for SRS. While the financial terms of SRS's many acquisitions since 2008 are not publicly available, we can say with a great deal of confidence that SRS paid considerably lower multiples when buying individual roofing materials distributors. Buying low and selling high is a winning strategy in any market environment.

Takeaways for Family Business Directors

Few of our readers will sell their family business to a company like Home Depot for \$18 billion. Even so, there is plenty for directors to chew on from this transaction. We'll highlight three in closing.

#1 - Don't underestimate the power of M&A in strategy execution.

Many families are (rightly) proud of their organic growth story. Slow and steady often does win the race, especially when success is measured over generations rather than quarters. Yet, industry and competitive dynamics don't always wait. Remember that great-grandpa was an innovator in his day. If your family business is losing momentum, prudent M&A can open up strategic market adjacencies and reaccelerate growth for the next generation.

#2 - Look at your family business like an acquirer would.

We've long advised clients to ask themselves if their businesses are "ready for sale." This does not mean that we think our clients should sell, it just means that they will find owning the business more rewarding if they think like a seller and do the things that make businesses attractive to buyers now rather than later. SRS's website includes a description of their ideal acquisition **candidate** that aligns very well with our READY framework.

Ideal Candidate

- Strong management team looking to remain with the business
- Strong market reputation with both vendors and customers
- Track record of consistent profitability
- Management has vision for the future of the business
- Clean operational history

#3 - Think like a private equity firm.

This may seem a bit scandalous to many family business leaders. However, we are not suggesting that family businesses should shed their legacies and start acting like ruthless corporate raiders. Rather, it is simply a reminder that family capital is scarce, and your family shareholders bear an opportunity cost when they let you manage that capital by keeping it in the family business. The private equity "playbook" components noted above can generally be adapted to your family business in a way that fits your culture, legacy, and preferences.

- Do you have a process for evaluating, recruiting, and incentivizing senior managers?
- Do you have a process for benchmarking profitability against a relevant set of peers to identify best practices for operating efficiency?
- Do you have a process for soliciting family shareholder preferences regarding capital structure and leverage decisions?
- Are you evaluating opportunities to enhance the value of your family business through accretive acquisitions?

Our readers in the construction materials space should definitely take some time to think about what the Home Depot / SRS deal means for them. However, as outlined in this post, the transaction offers ample food for thought for any family business.



Travis W. Harms, CFA, CPA/ABV

901.322.9760 | harmst@mercercapital.com



What to Look for in a Quality of Earnings Provider

The cost of M&A failures is high for both buyers and sellers of family businesses.

- For buyers, overpaying for a target can hamper returns and crowd out other more attractive investment opportunities for years to come.
- Sellers only get one chance to sell their businesses. Failing to maximize proceeds represents a missed opportunity they can never get back.

These high stakes mean that thorough and high-quality due diligence is critical. A Quality of Earnings (or QofE) analysis is an essential component of transaction diligence for both **buyers** and **sellers**. Optimizing your transaction diligence requires assembling the right team.

In this article, we discuss four things buyers and sellers should look for when evaluating potential QofE providers.

1. Transaction Experience

Don't view your QofE analysis as a mere "check box" on your diligence list. A QofE report should provide genuine insight about the target before you reach the closing table. While a QofE analysis can, in some respects, feel like an audit, it is not one. Instead, it is a component of transaction diligence, so you should inquire about a potential provider's transaction experience.

- Has the QofE provider represented buyers or sellers in transactions?

- Has the QofE provider advised buyers on M&A strategy?
- Has the QofE provider rendered fairness or solvency opinions?

2. Valuation Perspective

A quality of earnings analysis is not a valuation. However, every valuation includes an assessment of earnings quality. A QofE provider that brings a valuation perspective to the engagement is more likely to identify insights that matter to the proposed transaction price (i.e., valuation). Because of the close connection between QofE analysis and valuation, you should inquire as to a potential provider's valuation perspective.

- Does the QofE provider have an active valuation practice?
- Do any of the QofE provider's team members hold recognized valuation credentials?
- Do the members of the QofE provider's team undertake continuing professional education in valuation topics?

3. Technical Expertise

A quality of earnings analysis requires attention to detail, a thorough understanding of generally accepted accounting principles, and familiarity with the practical elements of accounting practice. Certified public accountants with audit experience are likely to possess each of these attributes.

- Does the QofE provider's team include one or more experienced CPAs?
- Does the QofE provider's team include members with audit or industry experience?

4. A Deep Bench

Transactions don't wait. When it is time to move on a deal, you can't waste time waiting for your QofE provider to catch up. When evaluating QofE service providers, you should inquire about the depth of resources they can bring to your assignment.

- Does the QofE provider have multiple engagement leaders capable of overseeing your engagement?
- Does the QofE provider have a pool of qualified staff capable of executing on the engagement on your timetable?

Conclusion

Successful buyers and sellers take Quality of Earnings analyses seriously. This requires taking care to select a QofE provider that can be a valuable member of your transaction diligence team. The best QofE providers generate relevant insights before you close your transaction – those insights are most likely to come from a team with a broad and deep technical skill set, transactional experience, and a valuation perspective.



Travis W. Harms, CFA, CPA/ABV

901.322.9760 | harmst@mercercapital.com



Nicholas J. Heinz, ASA

901.322.9788 | heinzn@mercercapital.com

Want to Learn More About a Quality of Earnings Analysis?

In this whitepaper, we illustrate how buyers and sellers benefit from a quality of earnings report.

We review the most common earnings adjustments applied in QofE analyses.

We also review the role of working capital and capital expenditures as the links between EBITDA and cash flow available to buyers.

Download our latest whitepaper



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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

Timothy R. Lee, ASA

901.322.9740
leet@mercercapital.com

Nicholas J. Heinz, ASA

901.322.9788
heinzn@mercercapital.com

Bryce Erickson, ASA, MRICS

214.468.8400
ericksonb@mercercapital.com

Andrew B. Frew, ASA, ABV

832.966.0345
frewa@mercercapital.com

Matthew R. Crow, ASA, CFA

901.322.9728
crowm@mercercapital.com

J. David Smith, ASA, CFA

832.432.1011
smithd@mercercapital.com

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