"I Want This To Be In Good Hands" – Emotional Pricing Of Resigning Entrepreneurs

BY

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1. Aim of the paper

Exiting the business is a major event for almost any entrepreneur with important implications for the firm owner, the firm, and all its stakeholders. The exit process itself comprehends a large number of considerations, choices, negotiations, and ultimately actions by the incumbent firm owner. Many entrepreneurs ultimately decide for selling the business, for instance to family members (FBO), employees (MBO), external individuals (MBI), or other firms. For such business transfers, the entrepreneur's expectations regarding the sales price of the business are crucial, as they potentially affect not only the speed of the transaction process and the satisfaction of all parties involved, but also whether the transfer of the business takes place at all: If the resigning entrepreneur's expectations regarding the price of the firm are too high, potential successors might be alienated and ultimately withdraw from the transfer negotiations. Consequently, the pool of potential successors diminishes with increasing price expectations, and, in the extreme case, no adequate succession candidate will remain to take over the business. Low sales price expectations of the entrepreneur, on the other hand, might entail low actual transaction prices and, as a consequence, endanger the entrepreneur's retirement provisions.

Applying a rational perspective, one would suppose that the entrepreneur expects a sales price that mirrors the actual (market) value of the firm. However, this assumption neglects an important emotional component of the selling process. A large body of theoretical and empirical research indicates that entrepreneurs are often not only concerned about the amount of their harvested value but also the quality of exit and the future prospects of "their baby." In a qualitative, multi-case study, Eisenhardt and Graebner provide evidence that entrepreneurial USbased high tech firms were not sold to the bidder with the highest offer but rather to prospective buyers who “fit” best with the company’s values and culture. Exiting owners appear to care for the firm’s future prosperity, even after the ownership transfer has occurred. Scholars attribute this desire to the entrepreneur’s emotional attachment to the firm and argue that this attachment, in turn, affects the emotional value that owners associate with the business. Empirical work carried out in the family business context indeed shows that long times of exposure to the business affect the owner’s minimum acceptable sales price when considering transferring the business to family-external individuals.

However, despite the relevance of sales price expectations in the context of entrepreneurial exits, there is still a lack of understanding about *the drivers of those expectations*. With this study, we aim to contribute to filling this gap. In particular, we strive to answer the following research questions: How do prior (1) firm performance, (2) choice of preferred exit route, and (3) entrepreneurial tenure (which goes along with emotional attachment) independently and in interaction affect entrepreneurs’ sales price expectations?

2. Contribution to literature

Building on literature on entrepreneurial exit, family firms, and behavioral economics, we argue that several firm-related aspects (firm performance) and aspects related to the entrepreneur (emotional attachment, relationship to potential successor) affect the pricing expectations of resigning entrepreneurs. We argue that under bad firm performance, entrepreneurs fear the discontinuance of their firm – a scenario they want to avoid at any price – and are thus willing to provide large discounts. Moreover, we discuss that entrepreneurs are likely to be willing to give “discounts” to those potential successors whom they trust to continue the business in the desired way and to keep the resigning entrepreneur further informed. We then discuss how the CEO’s tenure, which has been found to go along with emotional attachment, affects his or her pricing expectations independently and in interaction with the above mentioned aspects. Specifically, we deduce the following hypotheses:

> *H1: The worse the financial performance of the firm, the lower the entrepreneur’s sales price expectations (relative to market value).*
>
> *H2: The closer the relationship between incumbent and successor, the lower the entrepreneur’s sales price expectations (relative to market value).*
>
> *H3a: The higher the entrepreneur’s tenure within the firm, the lower the entrepreneur’s sales price expectations (relative to market value).*
>
> *H3b. Entrepreneurial tenure within the firm moderates the positive relationship between firm performance and sales price expectations.*

H3c. Entrepreneurial tenure within the firm moderates the negative relationship between closeness to the successor and sales price expectations.

Our research advances literature on entrepreneurial exits in multifold ways. First, it shifts the focus to sales prices, an important yet so far underinvestigated element of many exit processes. In particular, we draw the focus on emotional pricing. Second, our empirical findings indicate that entrepreneurs indeed care about the post-exit future of their firm and adapt sales prices to their level of "closeness" or trust to the successor. Third, we further advance scholarly knowledge of how the financial performance of the firm affects the entrepreneurial exit. Fourth, we show how entrepreneurial tenure within the firm, which is associated with increasing emotional attachment, affects entrepreneurial exit intentions. Moreover, by providing empirical evidence on sales price differences between family-internal and family-external transfers, we also contribute to family business research.

3. Data and results

We used two sets of survey responses in order to test our hypotheses: one on planned business transfers and one on actual, recent business transfers (the latter for a post hoc test on selected hypotheses). Applying a key informant approach, we sent a physical questionnaire to a random sample of CEOs of SMEs in Switzerland (address data acquired via the Dun & Bradstreet database). We received 1'354 complete survey responses on intended business transfers and 455 responses on actual successions.

(Subjective) firm performance was measured using a 4-item, 7-point Likert scale comparing the firm's performance over the last three years to those of competitors. To assess the emotional pricing, we asked respondents to indicate for how much, as compared to the firm's actual value, they would transfer the firm. The respondents of our survey could choose among 8 categories: 0% (1), 1-20% (2), 21-40% (3), 41-60% (4), 61-80% (5), 81-99% (6), 100% (7), more than 100% (8). We chose to ask for relative data on sales price expectations as opposed to asking for absolute numbers, an approach chosen for instance by Zellweger and colleagues (2012), because relative data is considered less sensitive. To operationalize the closeness of the future successor to the entrepreneur, we asked for the type of planned exit route. We thereby assumed that family members are closest and family- and firm-external individuals (MBI, sales to firm) are least close. More specifically, we asked the respondents to whom they plan to transfer the ownership of their firm at the time of their exit. Respondents could choose among the following answers, which were later dummy coded: Sales to family member(s) (FBO), sales to employees (MBO), sales to external person(s) (MBI), sales to other business (sales to firm), others. The variable "tenure" was calculated by subtracting the year of entrance from the year when this study was conducted (2013). We further included a series of control variables, such as firm age, size, industry, entrepreneur’s gender, and dummies for family firms and for the firm being part of the entrepreneur’s plan. The questionnaire was adapted accordingly for the subsample on actual transfers.

Results of an OLS regression based on sales price expectations support hypotheses H1, H2, and H3a and reject hypotheses H3b and H3c. The subsample with data on actual business transfers provides further support for hypothesis H2 but no support for hypothesis H1.

4. Discussion and practical implications

Our results contribute to the emerging stream of research on entrepreneurial exit processes. We study a topic – emotional pricing – that has implicitly been noted in several studies, but has received little explicit investigation so far. Valuation of the firm is an important component of the entrepreneurial exit process as it determines the satisfaction with as well as the probability of a (successful) exit process.

Our results show that most entrepreneurs do not expect to transfer the business at market value. Indeed, the average expected sales price is slightly above 70% of the considered market value. This finding is in line with prior empirical studies, which reveal substantial discounts as compared to market value for transactions including unlisted companies. We found that entrepreneurs strongly rely on the firm’s performance when considering emotional discounts to the market value. Our findings related to H1 extend prior work by providing a more nuanced understanding of the performance – entrepreneurial exit relationship. Moreover, they indicate that owners’ performance attainment discrepancies, which have been shown to affect firm behavior in several contexts, are also relevant for entrepreneurial exits.

Second, our results reveal a strong dependence of sales price expectations on the chosen exit route. Specifically, family members receive the largest discount (42%), followed by firm transfers to friends (30%). Other family-external individuals who take over the company (MBO, MBI to unknown person) have to pay 74% of the firm’s market value on average. Firms taking over the entrepreneur’s former business have to pay most as they only achieve 22% discount. Our findings support the notion that not only sales price matters for the resigning entrepreneur but also whom the business is transferred to.

In service industries, discounts are typically higher than in production. One could explain this observation by the higher proportion of immaterial as opposed to physical assets in service firms. Moreover, the larger the business, the larger the emotional discounts. Owners of SMEs, particularly in rural areas, are challenged by low “supply” of willing and capable successors, who are able to finance the transaction. This challenge grows with the market value of the firm. Lowering the sales price might thus be a potential remedy to ultimately find a successor. As expected, entrepreneurs, who perceive their business as component of their pension plan, are less willing to give a discount to their successor. Moreover, our regression analysis shows that *expected* sales prices do not depend on the gender of the resigning entrepreneur, while *actual* sales prices do: Female entrepreneurs provide larger discounts than male ones.

Our findings also carry about important practical implications. They reveal the importance of “closeness to the resigning entrepreneur,” a finding, which might guide incoming entrepreneurs in their search process. Investing in building up long term relationships with the entrepreneur might ultimately pay off financially for the succession candidate. For the resigning entrepreneurs, awareness of how the perceived financial performance distorts the sales price expectations is of value. Entrepreneurs, who are aware of this bias, might re-set and in particular raise their sales price expectations.

5. Key References

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