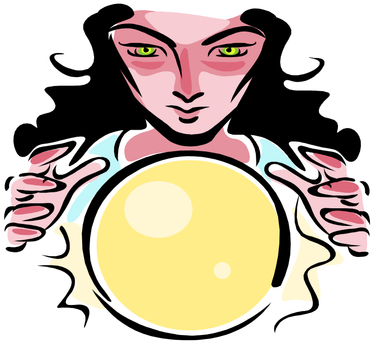
ACCREDITED BUSINESS APPRAISALS & BROKERAGE

Business & Real Estate Appraisals, & Business Brokerage

Jeffrey B. Wolpin, CBA, CREA, CCRA, MBA:

What Is YOUR COMPANY Worth?



Practical Techniques for Valuing and Pricing a Small Business for Sale

THE SELLER

Potential Seller Comes To You About Selling His Business, And He Tells You What He Thinks His Business Is Worth:

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THE BROKER

After Regaining Your Composure.
You Now Have To Tell Him What It Is Really Worth.

Here Are Some Practical Methods
For Pricing & Valuing A Business.

State of the Industry – Appraisal vs. Brokerage

APPRAISERS VS. BROKERS

APPRAISERS HAVE TECHNIQUE BUT OFTEN LACK JUDGEMENT.

BROKERS HAVE JUDGEMENT BUT OFTEN LACK TECHNIQUE.

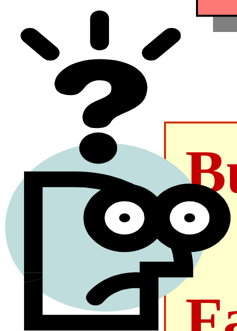
State of the Industry – Appraisal vs. Brokerage

<u>IN THE APPRAISAL WORLD,</u>
THE VALUE OF ANY BUSINESS IS THE VALUE TODAY OF ALL THE FUTURE BENEFITS OF OWNERSHIP!!!

ALL VALUATION METHODS AND PROCEDURES ATTEMPT TO MEASURE THAT FUTURE EXPECTATION.

<u>IN THE REAL WORLD,</u>
THE VALUE OF A BUSINESS, LIKE ANY ASSET, IS WORTH WHAT A BUYER WILL PAY FOR IT.
GETTING MAXIMUM VALUE REQUIRES MAXIMUM EXPOSURE.

State of the Industry – Appraisal vs. Brokerage



Business Appraisers like to use fancy jargon like:

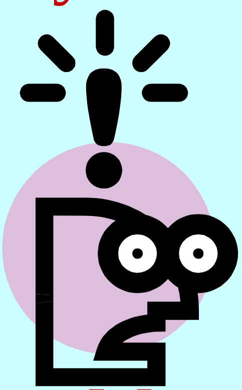
Fair Market Value
CAP-M – Capital Asset Pricing Model
WACC – Weighted Average Cost of Capital
Arithmetic & Geometric Mean
Ibbotson Data
Coefficient of Variation
Monte Carlo Simulation

Most of it is irrelevant to pricing and valuing small businesses for sale.

State of the Industry – Appraisal vs. Brokerage

Additionally, Business Appraisers are like Economists:

If you ask 2 appraisers what they think the value of your company is, you will get 3 opinions.



Or

Many appraisers will go through a lot of complex computations and procedures, just to end up telling you how many angels can dance on the head of a pin.

Basic Valuation Approaches

1. *Rules of Thumb*
2. *Asset or Cost Approach*
   a) *Valuation of Balance Sheet Assets*
   b) *Excess Earnings Method*
3. *Income Approach*
   a) *Present Value of Future Returns*
   b) *Capitalization of Income*
4. *Market Approach – Comparison to Sales of Similar Companies*
   a) *Price to Earnings of Cash Flow Multiples*
   b) *Price to Sales Multiples*
5. *Justification of Purchase Tests*

Typical Rules of Thumb

Small Businesses Sell for 1.5x – 4x SDCF
Where in that range does your business fall?

Two Sources for Rules of Thumb are:

1) Handbook of Small Business Valuation Formulas and Rules of Thumb, by Glenn Desmond, Valuation Press

2) Business Reference Guide, by Tom West, Business Brokerage Press.

Ranges for multipliers tend to be broad in each book, some with as much as a 100% spread, and the multipliers tend to be affected by local factors. Consequently, accuracy is problematic.

However, each book is very good on sources for Trade Associations to confirm the multipliers and factors affecting value.

Factors Affecting Rules of Thumb

1) Seller and Buyer Motivations – The 4 D's
2) Appearance of Facilities
3) Cash Flow and Sales Trends
4) Competition
5) Condition of Inventory or Merchandise
6) Covenant Not to Compete
7) Ease or Difficulty of Entry in Business
8) Local and Regional Economic Trends
9) Industry Outlook
10) Lease Terms
11) Location
12) Longevity in Business & Repeat Patronage
13) Reputation
14) Terms of Sale

Apply numerical factors to each to determine the appropriate multiple.
Ex: If the Multiple Range is 1X – 2X SDCF, then apply fractional values to each item to add up to the multiple you think the company will sell for.

Adjusting the Income Statement for Determining Seller's Discretionary Cash Flows

Pre-Tax Earnings

+ Interest

+ Depreciation

+ Owner's Salary

+ Salaries Paid to Non-Working Relatives

+ FICA Adjustments For Relative's Salaries

+ Expenses for Unnecessary Cars

+ Expenses for Unnecessary Owner Toys

+ Rents over Fair Market Value

+ Other Non-Operating Expenses

Seller's Discretionary Cash Flows

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Rule of Thumb Method	
Seller's Discretionary Cash Flows (or Revenues)	$ 85,000
Industry Multiplier for SDCF (or Revenue)	1.5
Enterprise Value	$ 127,500
Add: Necessary Working Capital (Inventory, Cash, & Other Current Assets)	$ 10,000
Less: Any Outstanding Debt	$ (5,000)
Equity Value (which Includes WC, Fixtures & Intangibles)	$ 132,500

Typical Rules of Thumb

Auto/Lube Tune Up:	55%	Gross Sales
	1.5X - 3X	SDCF
Auto Repair:	35%	Gross Sales
	1 - 2.25X	SDCF
Car Wash - Full Service:	100%	Gross Sales
	4 - 6X	EBIDTA
	1.75 - 2.25X	SDCF
Plus:	Inventory	& Equip.
Cash Business - Count the Cars.		
Car Wash - No Gas:	100%	Gross Sales

Typical Rules of Thumb

Coin Laundries:	80%	Gross Sales
	2.6 X	SDCF
Plus:	Inventory	
Factors:		
Condition of Equip.		
Lease, Vending Prices & Area Demographics		
Convenience Stores:	10%	Gross Sales
No Beer or Gas	4 - 6X	SDCF
Plus:	Inventory	
Convenience Stores:		
With Beer & Gas	22%	Gross Sales
	2.5 - 3.5X	SDCF
Plus:	Inventory	

Typical Rules of Thumb

Donut Shops:	50%	Gross Sales
	2 - 2.5X	SDCF
Plus:	Inventory	
Franchise Donut Shops	50% - 100%	Gross Sales
Plus:	Inventory	
Dry Cleaners:	50% - 110%	Gross Sales
	2.3 - 2.5X	SDCF
Plus:	Inventory	
Factors:		
Age & Cond. Of Equip., Location, Pick-up Service		
Grandfathering on Chemical Usage or		
Conversion to Environmental accepted Chemicals		

Typical Rules of Thumb

Employment Agencies:	50%	Gross Sales
	1 - 1.5 X	SDCF
Plus:	Inventory	& Equip.
Florists:	35%	Gross Sales
	1.7X	SDCF
Plus:	Inventory	

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Typical Rules of Thumb

Gas Stations - Full & Self Serve:	2 - 3X	SDCF
	1.5 - 2X	SDCF w/ service bays
		pumping 100K gals/mo
		$20K/mo or less in bays
	2 - 2.75X	SDCF w/ service bays
		pumping 150K+ gal/mo
		$40K/mo from bays.
Plus:	Inventory	& Equip.
Factors: Pooled Margins (87, 89, 91 Octane Combined)		
Location & Whether real estate is included.		
Gas Stations - With Mini Marts:	2.75 - 3X	SDCF
		pumping 200K gals/mo.
		$35K + / mo. From Mart.
	2.5 - 3.5X	SDCF
		pumping 250K gals/mo
		$50K+/mo from Mart
	14%	Gross Sales

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Gift Shops:	32%	Annual Sales
	1.5X	SDCF
Plus:	Inventory	
Gift Shops - Hallmark:	40%	Annual Sales
Ice Cream/Yogurt Shops:	45 - 50%	Annual Sales
	1 - 1.5X	SDCF
Plus:	Inventory	& Equip.
Liquor Stores:	25%	Gross Sales
	2X	SDCF
Plus:	Inventory	
Pet Stores:	35%	Gross Sales

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Typical Rules of Thumb

Pizza Shops:	**35-40%**	**Gross Sales**
	1.5 - 2X	**SDCF**
Plus:	**Inventory**	**& Equip.**
Sporting Goods Stores:	**30%**	**SDCF**
Plus:	**Inventory**	
Tanning Salons:	**70-75%**	**Gross Sales**
Tire Stores:	**25%**	**Gross Sales**
Plus:	**Inventory**	
Vending Routes:	**65-70%**	**Gross Sales**
	2X	**SDCF**
Video Stores:	**55%**	**Gross Sales**
	1X	**SDCF**
Plus:	**Inventory**	**& Equip.**

Excess Earnings Method

- **This method is a step up from the Rules of Thumb Methods in formality and has some striking similarities.**

- **In its simplest form it is very intuitive, showing how one can get a "Return Of" and a "Return On" ones investment in any particular small business.**

- **Like the Capitalization of Earnings Method it assumes a constant growth rate for the business into the future.**

Asset Approach - Excess Earnings Method		
UNADJUSTED PRE-TAX 2001 EARNINGS (Projected for 12 Months)*:		$ 599,997
(+) Rent Paid - Actual ($6,800/month for 7,740 sf) + CAMs = .$0.879/sf/mos.	$ 81,600	
(+) Depreciation & Interest (If EBITDA is used, don't add back Depreciation & interest.)	5,709	
(-) Officer's Salary (Based on Bureau of Labor Statistics for SIC # 5531)	(90,000)	
(-) FICA and State Unemploy. Tax Officer's Salary 11.05% on $75,000)	(8,288)	
(-) Fair Market Value Rents (7,740 x $1.25/ s.f.) x 12 mos. (according to Jim Reed, appraiser)	(116,100)	
Total Expense Adjustments	(127,079)	$ (127,079)
ADJUSTED EARNINGS BEFORE ANNUAL CAPITAL CHARGES:		$ 472,918
(-) Estimated FMV Return on Appraised Value of Machinery & Equip. (Fair Return = Prime +2 = 6.25% x $196,830)	$ (12,302)	
(-) Fixed Assets Reserve for Replacements [(196,830 - $13,122) / 15 yr. useful life]	$ (12,247)	
(-) Fair Return on Net Working Capital [based on RMA Sales/WkCap of 8.5x for # 5531 ($553,400 x 6.25% prime+2)	$ (34,588)	
	$ (59,137)	$ (59,137)
EXCESS EARNINGS		$ 413,781
Excess Earnings Capitalization Rate		30%
FAIR MARKET VALUE OF "BEFORE CONDITION" GOODWILL		$1,379,271
Rounded		$1,379,000

Excess Earnings Method

The above method has similarities to many Rules of Thumb, in that it calculates needed working capital (inventory + equipment), and subtracts debt to get to an equity value.

Income Approach – Capitalization Rate Method

- A progressively more complicated method then Excess Earnings.
- It is best suited for larger businesses, generally $5MM in revenues or greater.
- However, for purposes of brokering businesses it can be a useful tool to ballpark a multiple or talk a seller into a probable price for his company.
- Its complication comes from:
  - the more detailed calculation required to get to net cash flows,
  - the more detailed build up to get to the capitalization rate, and
  - the required matching of the correct capitalization rate to the appropriate net cash flows.

Adjusting the Income Statement To Determine Net Cash Flows

Net Income (after taxes) Adjusted for Non-Operating Expenses

+ Depreciation & Amortization

- Anticipated Capital Expenditures (M & E)

- (Normal Working Capital Requirements) x (growth rate)

+ (Normal Long Term Debt) x (growth rate)

= Net Cash Flow to Equity

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Income Approach – Capitalization Rate Method

Building Up the Capitalization Rate for a Company	
Risk Free Rate of Return	5.1%
(20-30 Year Treasuries)	
+ Equity Risk Premium	7.2%
(Ibbotson's Stock Risk above Bonds)	
+ Small Stock Risk Premium	9.8%
(Ibbotson's 10-b Small Stock Risk over Large Stocks)	
+/- Industry Risk Premium	4.5%
(Ibbotson's Risk for the Industry over the Total Market)	
Total Base Level Risk Premium	26.6%
+/- Specific Company Risk	6.25%
(As subjectively determined by appraiser)	
Total Capitalization Rate for Subject Company	33%

CALCULATION OF COMPANY SPECIFIC RISK PREMIUM		
FOR BUILD-UP OF CAPITALIZATION RATE		
	Company Specific Risk Premium Calculation	
1	Depth of Management	1.00%
2	Importance of Key Personnel	1.00%
3	Established Management Procedures	-0.25%
4	Stability of Employees	-0.50%
5	Stability of Industry	1.00%
6	Level of Competition	2.00%
7	Diversification of Product Line	1.00%
8	Diversification of Customer Base	2.00%
9	Diversification/Stability of Suppliers	0.00%
10	Geographic Location	0.00%
11	Stability of Earnings	1.00%
13	Stability of Dividend Distributions	1.00%
14	Earnings Margins	-1.00%
15	Financial Structure (Leverage)	-0.50%
16	Return on Equity & Capital	-0.50%
17	Payables Management	-0.25%
18	Receivables Management	-0.25%
19	Years In Business	-0.50%
20	Company Reputation	0.00%
21	Company Specific Risk Premium	6.25%

Income Approach – Capitalization Rate Method

CAPITALIZATION OF CASH FLOWS / EARNINGS CONCLUSION

Average 5 Year Adjusted Cash Flows	**$510,229**
Divided By :	
Capitalization Rate	**25%**
Unadjusted Equity Value	**$2,040,914**
Less: Long Term Debt	**$0**
Adjusted Business Enterprise Value (Equity Value)	**$2,040,914**
Plus: Net Working Capital Difference bet. Actual & Benchmark	**$973,540**

This method tends not to be appropriate for small (mom & pop) businesses.

Market Approach – Comparable Data Method

- ❑ Highly intuitive Approach, but more difficult than it appears at first blush.

- ❑ Many issues arise as to the legitimacy and relevancy of the currently available Comps databases.

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Market Approach – Comparable Data Method

Franchise Restaurants	
Confidence Interval for Mean SP/REV	
Lower limit =	**0.3343**
Upper Limit =	**0.5382**
Margin for Error (Half Width) =	0.1020
% Margin for Error =	**23.4%**
Sample Mean =	**0.4363**
Standard Deviation =	0.3034
% Confidence Interval =	95%
Sample Size =	**34**

Franchise Restaurants	
Confidence Interval for Mean SP/SDCF	
Lower limit =	**2.2981**
Upper Limit =	**3.6483**
Margin for Error (Half Width) =	0.6751
% Margin for Error =	**22.7%**
Sample Mean =	**2.9732**
Standard Deviation =	2.0084
% Confidence Interval =	95%
Sample Size =	**34**

WHEN SELLING YOUR BUSINESS,
ARE YOU PREPARED TO LEAVE 23-25% ON THE TABLE?

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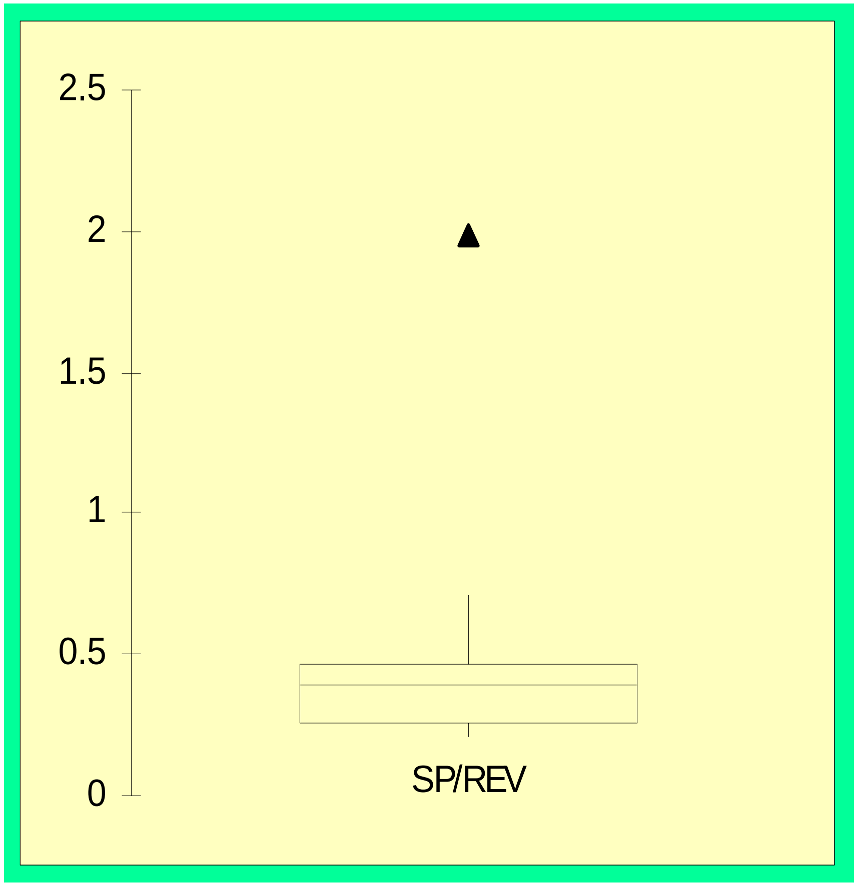
Market Approach – Comparable Data Method

Boxplot Output	SP/REV
First Quartile	0.2590
Median	0.3950
Third Quartile	0.4703
Interquartile Range	0.2113

Moderate Outliers (△)	0
Extreme Outliers (▲)	1



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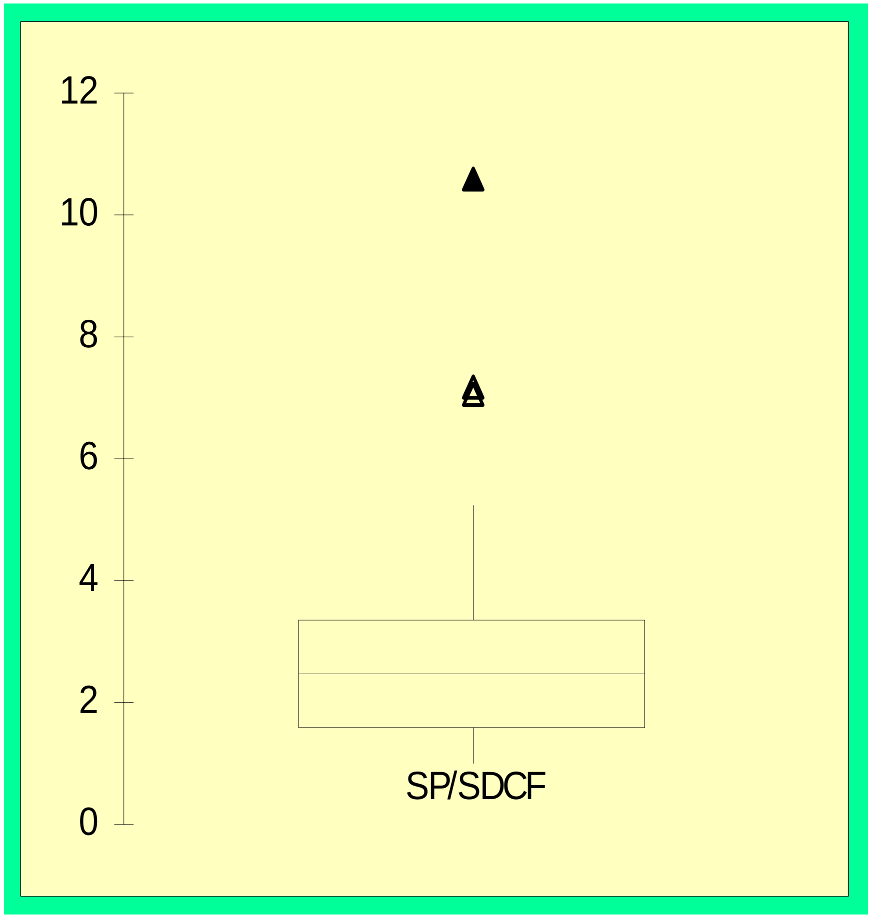
Market Approach – Comparable Data Method

Boxplot Output	SP/SDCF
First Quartile	1.5725
Median	2.5000
Third Quartile	3.3513
Interquartile Range	1.7788

Moderate Outliers (△)	2
Extreme Outliers (▲)	1



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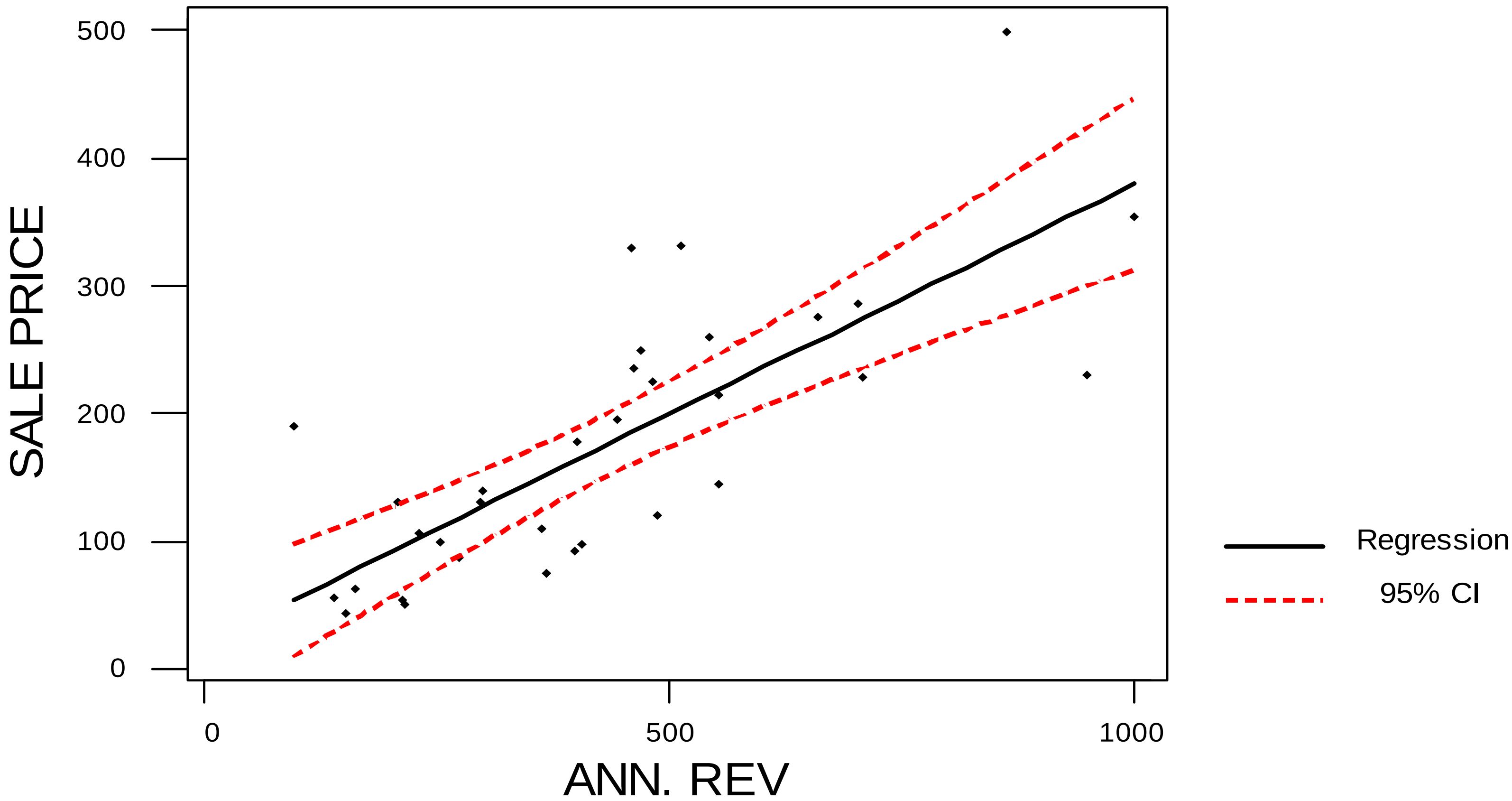
Franchised Restaurants - Sales Price To Revenues

SALE PRICE = 19.1049 + 0.360895 ANN. REV

S = 69.9499   R-Sq = 58.3 %   R-Sq(adj) = 56.9 %



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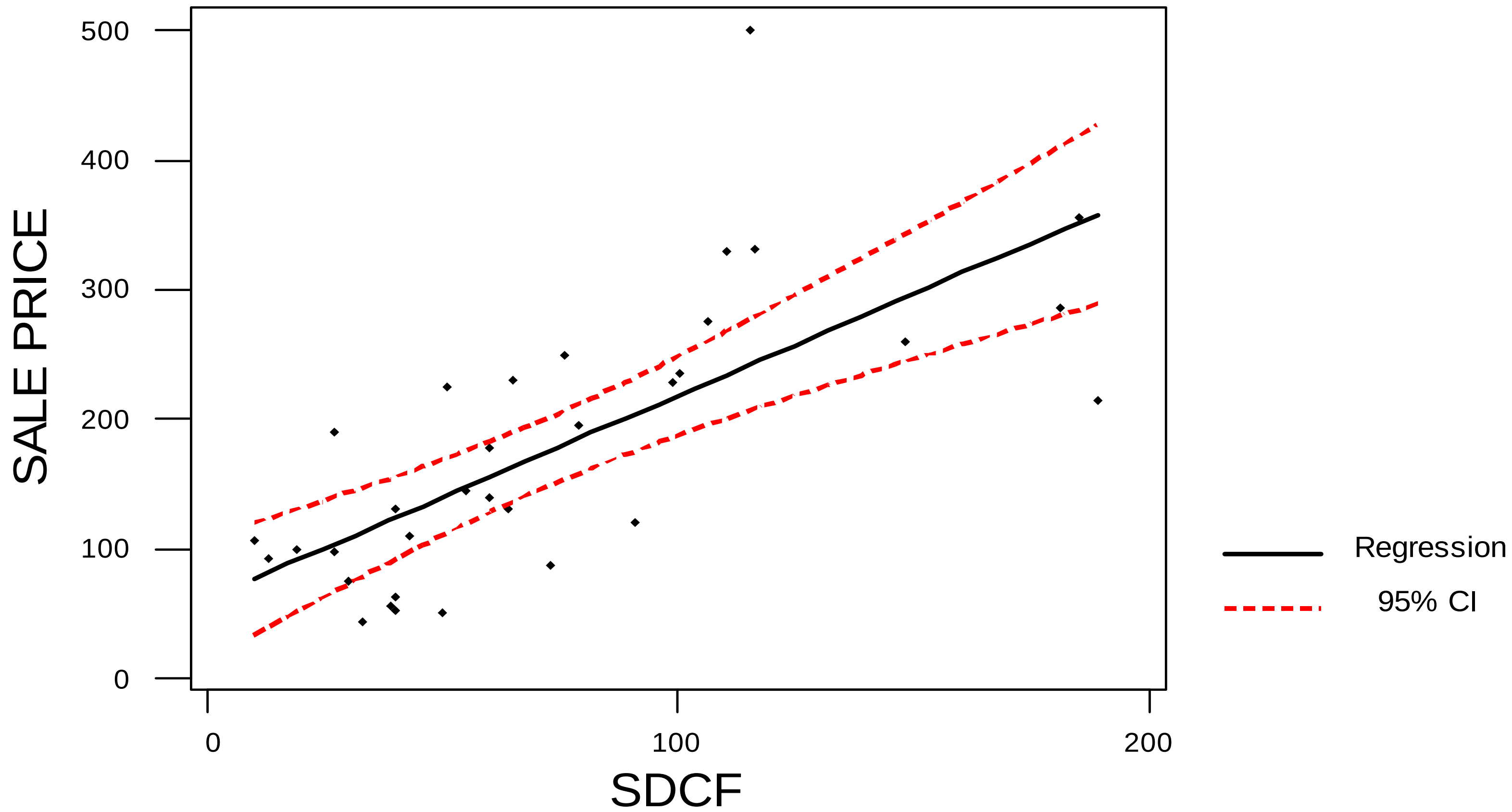
Franchise Restaurants - Sales Price To SDCF

SALE PRICE = 61.3725 + 1.56954 SDCF

S = 75.4589 R-Sq = 51.4 % R-Sq(adj) = 49.9 %



Justification of Purchase Test

- **What ever the final determination of the value of the business, the price and the deal have to work, i.e., the price of the business have to be supported by the cash flows and the terms of the debt.**

- **After all is said and done this method is probably the <u>most relevant</u> in determining whether the price of the business can be supported.**

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Justification of Purchase Test for Small Businesses	
Seller's Discretionary Cash Flow	$ 85,000
Less: Living Requirements for Business Owner (Salary)	$ (50,000)
Less: Necessary Expenses to Run the Business (ex: Working Capital & Replacement Costs)	$ (10,000)
Leaves Amount Required to Service Debt (Int. & Principal)	$ 25,000
Assume 5 Year Debt payoff (or whatever the term)	$ 125,000
Add Amount for Down payment	$ 28,305
Suggested Selling Price	$ 153,305

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Justification of Purchase Test for Mid Size Co's	2002	2003	2004	2005	2006	2007
Net Cash flow	$ 488,044	$ 592,267	$ 709,510	$ 847,275	$ 1,019,487	$ 1,070,461
Debt Service after tax effect	$ (346,959)	$ (346,959)	$ (346,959)	$ (346,959)	$ (346,959)	$ (346,959)
Cash Flow After Acquisition	$ 141,085	$ 245,308	$ 362,551	$ 500,316	$ 672,528	$ 723,502

Control Value	$ 2,597,000
Asset Loan	$ -
Amount of Seller Financing	$ 2,597,000
Down payment at 30%	$ 779,100
Seller Loan	$ 1,817,900
Total Financing	$ 1,817,900
Level Interest at 8%	$ 145,432
Level Principal on 7 year loan.	$ 259,700
Total Int. & Principal	$ 405,132
Tax effect Interest Exp at 1- 40%	$ 87,259
Interest & Principal Cash Flow deduction	$ 346,959

FORECAST	
YEAR	PAYMENT
Beg. Year 1	$ (779,100.00)
End Year 1	141,084.80
End Year 2	245,307.80
End Year 3	362,550.80
End Year 4	500,315.80
End Year 5	672,527.80
End Year 6	723,502.15
GUESS	36.50%
NPV	($2,668.00)

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Survey of Average Business Appraisal Fees			
	2002	2003	% Chg.
FLP	$ 4,901	$ 4,947	0.9%
Estate & Gift Tax	$ 5,477	$ 6,145	12.2%
Divorce	$ 6,325	$ 6,785	7.3%
Purchase/Sale	**$ 6,153**	**$ 6,435**	**4.6%**
Buy/Sell	$ 4,720	$ 5,717	21.1%
Succession	$ 4,955	$ 5,403	9.0%
M & A	**$ 7,028**	**$ 8,554**	**21.7%**
ESOP	$ 7,387	$ 8,719	18.0%
Charitable	$ 4,942	$ 5,668	14.7%
Bankruptcy	$ 6,667	$ 7,468	12.0%
Fairness Opinion	**$ 4,712**	**$ 7,950**	**68.7%**
Franchise	$ 5,327	$ 5,667	6.4%
Eminent Domain	$ 5,325	$ 5,611	5.4%
IPO	$ 14,429	$ 21,510	49.1%

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APPRAISAL PRICES

Grobstein, Horwath & Co.

To Cover Big Overhead & Staff Salaries

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APPRAISAL PRICES

MY PRICES

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