

# *Best Practices in Valuing Small, Closely Held Businesses & Professional Practices*

*Presented by*

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## **Today's Agenda**

- **Valuing The Small Business**
- **Valuing Professional Practices**
  - **What makes them unique?**
  - **Personal goodwill**

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## Common Methodologies

- Transaction approach
- Capitalization of earnings
- Capitalization of excess earnings
- Rules of thumb

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## Market Approach

- “Since the appraisal subject is a small company, a market approach could not be used.”
- More difficult to obtain good market data for closely-held companies.
- Small businesses have little, if any, correlation with the public world.

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## Transaction Method

1. ValuSource Market Comps Database (Old IBA data)
2. BizComps®
3. DealStats®
4. Business brokers

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## Transaction Method Advantages

- Takes information directly from the market
- Easily understood by lay persons
- Many of the components of a business can be valued this way

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## **Transaction Method Disadvantages**

- Little information is often known about the transactions.
- Difficult to determine if truly comparable.
- Inconsistent information reporting.
- Method requires a reasonably active market for the type of business being valued.

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## **Income Approach**

- Capitalization of Earnings
- Capitalization of Excess Earnings

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## Capitalization of Earnings

- Income stream must be relatively stable.
- Many small businesses have stable earnings.
- Must determine normalized earnings (add back personal stuff).
- Must determine appropriate cap rate.
- Discount rates from the public market rarely applies to the closely held company.
- Once the valuation analyst overcomes these problems, this method can work.

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## Excess Earnings Method

- All of the operating assets and liabilities of the business must first be appraised.
  - Accomplished using the Adjusted Book Value method.
- Must calculate the normalized sustainable earnings of the business.
- Must determine the appropriate rates of return on the net tangible assets (other than goodwill) owned by the company.
- The return on the net assets is then subtracted from the normalized earnings resulting in "excess earnings" subject to capitalization.
- Must determine the appropriate capitalization rate for excess earnings.

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## Market Approach Example

- Valuation of a Pizzeria that also serves other types of Italian food.

**DO NOT PAY ATTENTION TO THE DATES IN THE EXAMPLE. THEY ARE IRRELEVANT.**

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## Database Search

- Searched for transactions involving companies in SIC code 5812 - Retail Trade, Eating Places.
- Our search located approximately 1,500 transactions in this SIC code containing all types of restaurants whose revenues ranged from \$13,000 to in excess of \$200,000,000.
- In order to more appropriately utilize this information, we stratified this data into several more applicable categories.
- The first category consisted of small Italian restaurants and pizzerias.

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### MARKET COMPARISON DATA ITALIAN RESTAURANTS/PIZZERIAS

Business Type	Annual Gross \$000's	Sales Price \$000's	Price/ Gross	Geographic	Yr/Mo of Sale
Deli with pizza	89	28	0.31	CA	86/04
Fast Food-Pizza	227	55	0.24	GA	93/07
Fast Food-Pizza	230	49	0.21	CA	94/12
Restr-Pizza	306	120	0.39	CA	90/05
Restr-Italian	310	29	0.09	CA	95/08
Pizza Delivery	317	81	0.26	TX	91/04
Restr-Italian	324	75	0.23	FL	94/05
Restr-Italian	390	53	0.14	CA	95/07
Restr-Pizza	477	397	0.83	ID	95/04
Restr-Italian	516	212	0.41	CA	95/08
Restr-Italian	653	89	0.14	CA	95/02
Mean			0.30		
Median			0.24		

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## Second Stratification

- The second category consisted of 55 restaurants categorized as fast-food restaurants.

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MARKET COMPARISON DATA FAST FOOD RESTAURANTS					
Business Type	Annual Gross \$000's	Sales Price \$000's	Price/ Gross	Geographic	Yr/Mo of Sale
Fast Food/Coffee Shop	58	23	0.40	FL	96/02
Fast Food-Yogurt	65	24	0.37	LA	93/12
Fast Food/Coffee Shop	74	60	0.81	FL	96/06
Fast Food-Smoothies	80	40	0.50	LA	95/02
Fast Food-Yogurt	86	27	0.31	LA	93/04
Fast Food/Coffee Shop	90	20	0.22	FL	95/09
Sandwich shop, fast food	90	34	0.38	Mid-West	86/07
Fast Food/Coffee Shop	100	32	0.32	FL	94/10
Fast food/coffee shop	108	50	0.46	FL	93/12
Fast food rest	111	20	0.18	Mid-West	87/02
Fast Food-Chicken	120	68	0.57	FL	94/04
Fast Food-Yogurt	120	52	0.43	FL	94/08
Fast Food-Chicken	120	40	0.33	FL	95/01
Fast Food/Coffee Shop	120	40	0.33	FL	95/02
Fast Food-Yogurt	120	38	0.32	TX	92/02
Restr-Mall Fast Food	120	48	0.40	FL	91/03
Fast Food/Coffee Shop	120	56	0.47	FL	94/08
Fast Food/Coffee Shop	132	27	0.20	FL	95/08
Fast Food-Chicken	132	25	0.19	FL	95/07
Deli, fast food	132	55	0.42	NJ	91/
Fast Food-Yogurt	135	70	0.52	Midwest	93/03
Fast Food-Yogurt	136	100	0.74	ID	92/07
Fast Food/Coffee Shop	140	85	0.61	FL	94/07
Fast Food/Coffee Shop	147	85	0.58	FL	94/08
Fast Food/Coffee Shop	150	65	0.43	FL	96/01
Fast Food-Baked Potatoes	152	43	0.28	MN	94/11
Fast Food-Yogurt	160	80	0.50	CA	92/01
Deli Fast Food	175	76	0.43	MA	90/09
Fast Food/Coffee Shop	175	70	0.40	FL	96/10
Fast Food-Dairy Queen	185	25	0.14	NM	92/09
Fast Food Dairy Queen	186	20	0.11	NM	91/10
Fast Food/Bakery/Coffee	200	95	0.48	FL	95/03
Fast Food/Coffee Shop	200	65	0.33	FL	96/11
Deli Fast Food	200	70	0.35	MA	90/08
Fast Food-Dairy Queen	220	99	0.45	Midwest	93/09

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Fast Food (Mall Store)	220	90	0.41	NC	96/10
Fast Food-Mexican	222	88	0.40	OR	95/03
Fast Food-Pizza	227	55	0.24	GA	93/07
Fast Food-Pizza	230	49	0.21	CA	94/12
Fast Food-Hamburgers	237	140	0.59	CA	91/08
Fast Food/Coffee Shop	250	128	0.51	FL	95/05
Fast Food-Dairy Queen	275	57	0.21	NM	91/07
Deli-Fast Food	285	83	0.29	FL	91/11
Fast Food/Coffee Shop	300	70	0.23	FL	97/05
Fast Food-Take Out	300	161	0.54	ID	95/09
Fast Food-Dairy Queen	312	117	0.38	NM	91/07
Fast Food-Dairy Queen	324	40	0.12	Midwest	94/01
Fast Food/Coffee Shop	346	150	0.43	FL	95/03
Fast Food/Coffee Shop	346	100	0.29	FL	95/06
Sub shop/fast food sand.	354	205	0.58	IL	89/
Fast Food-Ice Cream	354	185	0.52	CA	95/07
Fast Food-Roast Beef	398	93	0.23	CA	94/11
Fast Food-Fried Chicken	540	248	0.46	TX	94/08
Fast Food/Coffee Shop	832	200	0.24	FL	94/11
Fast Food-Hamburgers	832	200	0.24	FL	94/10
Fast Food-Hamburger	936	665	0.71	NV	90/07
Mean			0.39		
Median			0.40		

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## Third Stratification

- The final category consisted of restaurants with sales in the range of \$400,000 to \$700,000, regardless of type
- There were 168 transactions.

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### MARKET COMPARISON DATA REVENUES OF \$400,000 TO \$700,000

Business Type	Annual Gross \$000's	Sales Price \$000's	Price/ Gross	Geographic	Yr/Mo of Sale
Bagel shop	400	190	0.48	L I New York	90/03
Restaurant	400	125	0.31		84/02
Bagel restaurant	400	160	0.40	FL	95/01
Bagel restaurant	400	150	0.38	FL	95/04
Restr-Dinner House	400	178	0.45	NV	92/10
Deli, grocery	400	205	0.51		91/
Catering, off premise	400	215	0.54	NY	91/12
Restaurant	400	350	0.88	Northeast	98/01
Restaurant	400	95	0.24	NY	89/
Deli	400	120	0.30	CT	90/12
Restaurant with liquor	400	50	0.13	IL	93/
Coffee shop	400	60	0.15	Calif/Ariz/Nev	83/07
Own, op restaurants	400	500	1.25	GA	93/03
Own and operate restaur	400	300	0.75	KY	93/07
Sandwich shop	405	180	0.44	FL	94/12
Restaurant	407	120	0.29	FL	95/03
Restaurant-Family	408	69	0.17	MN	91/12

Mean	0.36
Median	0.34

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## Summary of Means and Medians

- Italian Restaurants
  - 11 Transactions
  - .30 and .24
- Fast Food
  - 55 Transactions
  - .39 and .40
- Size
  - 168 Transactions
  - .36 and .34

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## Multiples & Income Stream

- Revenue instead of earnings was used.
- Median used because mean can be skewed by data that are outliers.
- Three median multiples result in an average P/R multiple of 0.33.
- Analysis of historic and adjusted revenues indicated that revenues increased from 1993 through 1995, and then declined again.
- No consistent growth pattern over the past 5 years.
- Average adjusted revenues over the period will be used to reflect the future (\$703,067).

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## Value Estimate

Average Revenues	\$ 703,067
Price to Revenue Multiple	<u>x 0.33</u>
Value	\$ 232,012
Plus: Inventory	6,250
Less: Current Liabilities	<u>63,460</u>
Value of Operating Entity	\$ 174,802
Rounded	\$ 175,000

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## DealStats

- A search of SIC code 5812 revealed 32 transactions.
- Many of the transactions involved restaurant chains with revenues greater than several million dollars.
  - These are not considered to be comparable to the subject company.
- After removing the inapplicable transactions, the following transactions remained.

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DEAL STATS TRANSACTIONS					
Company Type	Sales Price	Revenues	Price to Revenues	Date of Sale	
Restaurant	\$ 100,000	\$ 474,900	0.21	8/1/97	
Restaurant	125,000	429,500	0.29	3/15/97	
Restaurant	160,000	533,500	0.30	3/16/97	
Restaurant	220,000	618,769	0.36	7/1/97	
Italian Restaurant	158,000	382,067	0.41	8/1/97	
Italian Restaurant	350,000	1,170,948	0.30	7/10/98	
Pizza	265,000	470,147	0.56	8/1/96	
Mean			0.35		
Median			0.30		

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## Value Estimate

- The median multiple for these transactions was 0.30.
- This falls within the range of the multiples determined using the previous database, which indicates that the multiple and value derived utilizing the other data is reasonable.

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## Rules of Thumb

- A final check of the multiple derived was *The 1998 Business Reference Guide*, edited by Thomas L. West, and published by Business Brokerage Press.
- According to the chapter entitled “Rules of Thumb,” the sales price to revenue multiple for restaurants in the category fast food - pizza was 0.35.
- Again, this figure reinforces the validity of the multiple determined with the transaction data.

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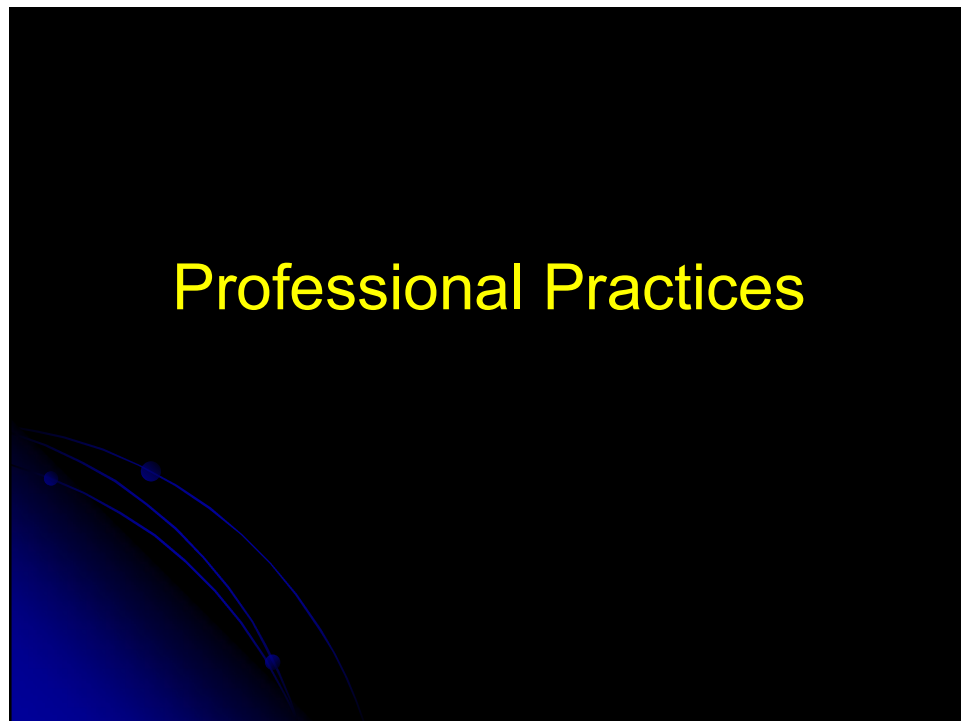
## Justification of Purchase Price

- Assumed Facts For Example:
  - 40 percent down payment
  - The valuation analyst uses the most recent income as indicative of future pretax income
  - Tax rate has been assumed at 40 percent.
  - Financing at a 9.25 percent interest rate (prime rate plus 1 percent)
  - Value of operating entity = \$4,371,810 (not really a very small business but it was a good example)

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	Year 1	Year 2	Year 3	Year 4	Year 5
Annual Payments	\$ 657,237	\$ 657,237	\$ 657,237	\$ 657,237	\$ 657,237
Interest	224,598	182,839	137,048	86,836	31,778
Principal	\$ 432,639	\$ 474,398	\$ 520,189	\$ 570,401	\$ 625,459
Cash Flow					
Pretax Income	\$ 935,233	\$ 963,290	\$ 992,189	\$ 1,021,954	\$ 1,052,613
Interest Expense	224,598	182,839	137,048	86,836	31,778
Taxable Income	\$ 710,635	\$ 780,451	\$ 855,141	\$ 935,118	\$ 1,020,835
Tax	284,254	312,180	342,056	374,047	408,334
Net Income	\$ 426,381	\$ 468,271	\$ 513,085	\$ 561,071	\$ 612,501
Principal Payments	432,639	474,398	520,189	570,401	625,459
Cash Flow	\$ (6,258)	\$ (6,127)	\$ (7,104)	\$ (9,330)	\$ (12,958)
Return on Down Payment	-0.36%	-0.35%	-0.41%	-0.53%	-0.74%

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## **Why Are Professional Practices Valued?**

- Mergers and acquisitions
- Estate and gift taxes
- Buy-sell agreements
- Stockholder/partner disputes
- Damages litigation
- Marital dissolution

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## **Characteristics of the Professional Practice**

- Service business where tangible assets are considerably less than intangible assets
- Strong relationship between the professional and the client/patient based on the professional's reputation
- Depends on a strong referral system to get new clients/patients
- Professional is frequently licensed, regulated or certified by a governmental or regulatory agency and/or professional organizations
- To get licensed or accredited, most professionals are required to obtain an undergraduate degree as well as maintain some level of continuing education

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## **Professional Practice Versus Other Business Valuations**

- Same general guidelines as with other types of business enterprises
- Since most of the value is in the intangible assets, market or income approach most often used
- Excess Earnings Method could be used but this method is problematic
- Excess Earnings Method should result in the same value as in the income approach since the tangible assets are relatively small

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## **The Document Checklist**

- **FOR ACCOUNTING PRACTICES**
  - Schedule of unbilled work in process as of the valuation date.
  - List of 5 largest clients over the past 3 years and the total amount of fees charged to each client in each year.
  - Breakdown of fees billed and collected over the past 3 years between audit, tax, compilation and review, management advisory services and all other.

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## The Document Checklist

- **FOR THE LAW FIRM**
  - List of all unbilled work in process as of the valuation date.
  - Detailed lists of books and services in law library.
  - List of 5 largest clients over the past 3 years and the total amount billed and collected from each client in each year.
  - Schedule of fees billed and collected broken down by specialty (e.g., criminal, municipal, real estate, matrimonial, etc.) for the past three years.
  - A schedule of all contingent fees received since the valuation date for all matters started prior to such date.
  - A list of all contingent matters that have not been finalized that were started on or before the valuation date.
  - A schedule of all contingent litigation matters for the past 3 years indicating fees received, professional hours billed and costs associated with each suit.
  - A schedule of all attorney time written off over the past 3 years.
  - List of all personnel broken down by status with the firm, department, etc. For professionals, please indicate specialization and the year admitted to the bar.

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## The Document Checklist

- **FOR THE MEDICAL PRACTICE**
  - List of items comprising medical supplies inventory (quantity, description and cost) as of the valuation date.
  - Information relating to accounts receivable submitted to a collection agency or law firm.
  - List of all hospital affiliations.
  - List of all specialties and/or sub-specialties.
  - Normal office hours for staff
  - Doctor's normal hours in office.
  - Typical hours patients are seen in office.
  - Typical hours of hospital rounds.
  - Percentage of services that are paid for by:
    - Cash or check:
    - Credit card:
    - Insurance:
      - Patient carrier payments:
      - HMO or capitation:
      - PPO or other
  - List of all managed care organizations that you currently belong to with a copy of the contract.
  - List of all managed care organizations that you belonged to in the past but are no longer affiliated with, including the year that you discontinued your affiliation with them.
  - Fee schedule by procedure for the past 3 years.
  - Breakdown of services provided by CPT code over the past 3 years.

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## **Issues Particular To The Professional Practice**

- **Cash vs. accrual accounting**
- **Accounts receivable**
- **Work in process**
- **Prepaid insurance**
- **Supplies**
- **Reasonable compensation**

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## **Cash Versus Accrual Accounting**

- **Cash basis usually used**
- **Balance sheet should be restated to capture all of the assets and liabilities of the practice**
- **Income statement may or may not be restated**
  - **Information might not exist to allow this to be done**
  - **Consistent trend - cash basis is probably a good reflection of the cash-generating capabilities of the practice**
  - **Practices are frequently sold using cash basis statements**
  - **The accrual assets and liabilities (accounts receivable and accounts payable) are usually kept by seller**

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## **Accounts Receivable**

- Nature of most professional practices is that accounts receivable can be fairly high
- Most smaller practices - record keeping may require the appraiser to use some accounting skills to figure out the correct balance

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## **Work in Process**

- One of the most difficult assets to value
- Contingent fee law firm most complicated
  - Appraiser may have to estimate WIP by using comparative data published by such companies as Altman Weil Pensa
- Utilization of subsequent information may be necessary
- Alternative - hire an experienced attorney to review all open cases and estimate value of files

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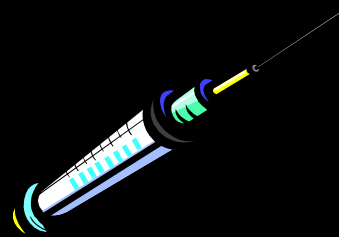
## Prepaid Insurance

- Important because of rising malpractice premiums
- Example
  - Medical practice pays \$120,000 in malpractice premiums on February 1 and is valued as of March 1
  - Since 11 months of the premiums are prepaid, the practice value increased (on the basis of its assets) by \$110,000
  - The entire premium should be reflected in the income statement
- Short-rating the policy
- Purchasing a tail policy
  - This could turn out to be a liability rather than an asset

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## Supplies

- Supply inventory could be material
- Certain medical practices maintain an expensive inventory of drugs



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## Reasonable Compensation

- The most important adjustment
- Factors to be considered include:
  - Job description
  - Hours worked
  - Education
  - Age
  - Special skills
  - Rainmaking ability
  - Size of the practice
  - Profitability of the practice

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## Valuation Calculations- Unique Aspects of The Calculations

- Greater emphasis placed on gross revenues
  - Willing buyer frequently purchases revenue stream
  - Willing buyer is often strategic or synergistic
  - May be the highest value for the practice

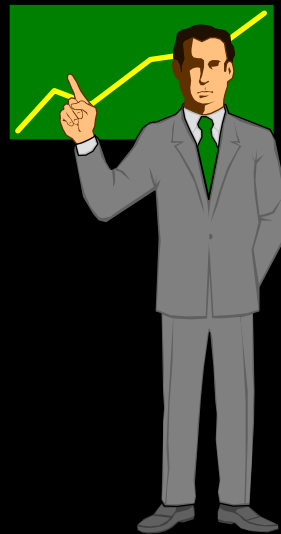
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## Personal vs. Practice Goodwill

- John Smith CPA or PWC?
- Transferability of the goodwill
- Referral sources
- Market realities
  - Sale of a law firm

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## Questions?



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