Business Valuation Training:

Hot Topics and Case Studies

Michigan Business Brokers Association – April 20, 2018

Presented by:

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reliant
BUSINESS VALUATION

- Neal Patel, CBA, CVA is the Principal of Reliant Business Valuation, a business valuation and equipment appraisal firm specialized in SBA related valuations nationwide.
- Recipient of Coleman Report's '2017 Emerging Leader Award'
- Our firm currently works with over 150 SBA lenders around the nation.
- Certified Business Appraiser through the Institute of Business Appraisers (IBA) (ex-Chair of the Board of Governors)
- Certified Valuation Analyst through the National Association of Certified Valuators and Analysts (NACVA).

Topics Covered

- SBA Guidelines / Updates
- Intangible Assets / Deal Structure
- Case Studies: Retail vs. Dentist
- Factors that Impact Value

When is a Third Party Valuation Required by SBA Lenders?

(Non Special Purpose Property)

If the amount being financed (*including any 7(a), 504, seller or other financing*) minus the appraised value of real estate and/or equipment is greater than $250,000, ***or..***

Note: no mention of goodwill!

If there is a close relationship between the buyer and seller (for example, transactions between family members or business partners), ***or..***

Note: employee / employer also included!

If the lender's internal policies and procedures require an independent business appraisal from a qualified source

Note: every change of ownership loan requires a business appraisal !

Who is a "qualified source" as per the SBA?

- (a) Accredited Senior Appraiser (ASA)
- (b) Certified Business Appraiser (CBA)
- (c) Accredited in Business Valuation (ABV)
- (d) Certified Valuation Analyst (CVA)
- (f) Business Certified Appraiser (BCA)

- (e) Accredited Valuation Analyst (AVA)*

**(the AVA designation was merged with CVA and dropped)*

NOTE: CPA is not considered a “qualified source” he/she also has an ABV credential.

Special Purpose Property
SOP 50 10 5(J) – pg. 197

- A **Special Purpose Property** is defined in the SOP as *"a limited-market property with a unique physical design, special construction materials, or a layout that restricts its utility to the specific use for which it was built."*

Special Purpose Properties from 5(J)

Examples of Special Purpose Properties (pg. 261 SOP 50 10 5(J))	
Amusement parks	
Bowling alleys	Mines
Car wash businesses	~~Museums~~
Cemeteries	Nursing homes, inc. assisted living facilities
~~Clubhouses~~	Oil wells
Cold storage facilities…	Quarries, including gravel pits
Dormitories	Railroads
Farms, including dairy facilities	Sanitary landfills
Hospitals, surgery centers, urgent care centers and other health or medical Facilities	Service centers (e.g., oil and lube, brake or transmission centers) with pits and in ground lifts
Funeral homes with crematoriums	Sports arenas
Gas stations	Swimming pools
Golf courses	Tennis club
Hotels, motels, and other lodging facilities	Theaters
Marinas	Wineries

Special Purpose Properties

- *"…the lender must obtain an independent business valuation performed by a Certified General Real Property Appraiser."* Additionally,
  - *The business valuation must allocate separate values to the individual components of the transaction including land, building, equipment and intangible assets.*
  - *The Certified General Real Property Appraiser must have completed no less than four going concern appraisals of equivalent special use property as the property being appraised, within the last 36 months, as identified in the qualifications portion of the Appraisal Report.*
  - *Each business valuation assignment under this section must be... in compliance with current USPAP guidelines.*

Alert: SOP 50 10 5(J) pg. 174
(effective Jan 1, 2018)

Minimum equity injection requirements for certain Applicants or loans:

(i) *Resulting in a new owner (complete change of ownership): SBA considers an equity injection of at least 10 percent of the total project costs* to be necessary for such change of ownership transactions.*

(ii) *Seller debt may not be considered as part of the equity injection unless it is on full standby for the life of the SBA loan* ***and*** *it does not exceed half of the required equity injection.*

**Project costs: all costs required to complete the change of ownership, regardless of the source of funds*

***Term W/C included, operating LOC excluded*

Alert: SOP 50 10 5(J) pg. 134
(effective Jan 1, 2018)

NEW: *If any of the loan proceeds will be used to finance intangible assets, the amount must be specifically identified in the Use of Proceeds section of the application and the Authorization.*

Intangible Assets: SOP Definition

SOP 50 10 5(J) pg. 134

The value of the intangible assets is determined by...the value of the business as identified in the business valuation minus the sum of the working capital assets and the fixed assets being purchased.

In other words:

intangible assets =
business value – (working capital* + fixed assets)

*Working Capital = Current Assets – Current Liabilities

Intangible Assets: SOP Definition

Final Value	$700,000
Cash or Cash Equivalent	$0
Accounts Receivable	$0
Inventory	$50,000
Other Current Assets	$0
Fixed Assets (net book value)	$100,000
Other Assets	$0
Total Tangible Assets Included in Value	$150,000
Current Liabilities	$0
Long Term Liabilities	$0
Total Liabilities Included in Value	$0
Assets less Liabilities (rounded)	$150,000
Final Value minus (Assets less Liabilities)	
Total Intangible Assets Included in Value	$550,000

Intangible Assets: SOP Definition

Final Value	$700,000
Cash or Cash Equivalent	$0
Accounts Receivable	$0
Inventory	$50,000
Other Current Assets	$0
Fixed Assets (**appraised** value)	$250,000
Other Assets	$0
Total Tangible Assets Included in Value	$300,000
Current Liabilities	$0
Long Term Liabilities	$0
Total Liabilities Included in Value	$0
Assets less Liabilities (rounded)	$300,000
Final Value minus (Assets less Liabilities)	
Total Intangible Assets Included in Value	$400,000

Intangible Assets: SOP Definition

Final Value	$600,000
Cash or Cash Equivalent	$0
Accounts Receivable	$0
Inventory	$50,000
Other Current Assets	$0
Fixed Assets (**appraised** value)	$250,000
Other Assets	$0
Total Tangible Assets Included in Value	$300,000
Current Liabilities	$100,000
Long Term Liabilities	$0
Total Liabilities Included in Value	$100,000
Assets less Liabilities (rounded)	$200,000
Final Value minus (Assets less Liabilities)	
Total Intangible Assets Included in Value	$400,000

Important Reminder: Transaction Type

The following paragraph was moved up to the top of the Business Valuation Requirements section, most likely due to the importance of its contents.

SOP 50 10 5(J) States: *"The scope of work should identify whether the transaction is an asset purchase or stock purchase and be specific enough for the individual performing the business valuation to know what is included in the sale (including any assumed debt)."*

- All assets <u>and</u> liabilities that are included in the final transaction must be included in the business valuation. This is similar to the basic concept of "comparing apples to apples".

Important Reminder: Transaction Type

SOP 50 10 5(J) States: *"The scope of work should identify whether the transaction is an asset purchase or stock purchase and be specific enough for the individual performing the business valuation to know what is included in the sale (including any assumed debt)."*

- It all depends on how the deal is structured!
- Asset Purchase – Typically FF&E, Goodwill and Inventory, but it can include other assets or liabilities.
- Stock Purchase – Typically all assets and liabilities, but it can exclude specific assets or liabilities.

The value of a business includes:

Cash Flow x Multiple = Asset Value

$215,000 x 3.0 = $650,000

- The value above includes:
  - all operating assets (FF&E)
  - all intangible assets (goodwill)

Important Reminder: Transaction Type Example 1

Enterprise value derived from previous slide…	
Enterprise Value	$650,000
+ Inventory	$50,000
= EV + Inventory	$700,000
If transaction includes $50M A/R	
+ Accounts Receivable	$50,000
	$750,000
If transaction also includes $50M A/P	
- Accounts Payable	-$50,000
	$700,000

Important Reminder: Transaction Type Example 2

Enterprise Value	$650,000
If transaction includes $200M in Target NWC	
+ Current Assets	$250,000
- Current Liabilities	-$50,000
= Net Working Capital	$200,000
Value includes Net Working Capital	
+ Value incl. NWC	$850,000
At closing, NWC balance should be confirmed.	

Alert: SOP 50 10 5(J) pg. 175

(effective Jan 1, 2018)

Minimum equity injection requirements for...

Change of ownership between existing owners ("partner buyout"):

1) *The pro-forma equity position after the change of ownership must be at least **10 percent of the total assets**.*
2) *Otherwise, the remaining owner(s) must provide an additional equity injection that will result in at least a **10 percent net worth** (maximum pro forma **debt-to-worth ratio of 9:1**).*

Alert: SBA Notice 5000-17057

(effective April 3, 2018)

In order for a 7(a) loan to finance greater than 90% of the purchase price of a partner buyout: :

- Remaining owner(s) must certify that he/she has been actively participating in the business and held the same ownership interest for at least the past 24 months (Lender must retain evidence in the loan file); and
- The business balance sheets for the most recent completed fiscal year and current quarter must reflect a debt-to-worth ratio of no greater than 9:1 prior to the change in ownership

Partnership Buyout

Can the owner’s existing equity in the business be used to satisfy the 10% “equity requirement”?

- Example: 10% partner is buying out a 90% partner’s ownership interest, resulting in 100% ownership vesting in the purchaser.
- The business valuation reflects a pre-sale stock value equaling $1,000,000
  - value includes all assets ($300,000 Cash, AR, Inventory and $300,000 liabilities (pre-sale))

Partnership Buyout

(My Interpretation (*subject to SBA clarification*))

	CURRENT	PROFORMA		
Assets			PostClosing	
Cash	$ 100,000		$ 100,000	
Accounts Receivable	$ 100,000		$ 100,000	
Inventory	$ 100,000		$ 100,000	
Other	$ -		$ -	
Total Current Assets	**$ 300,000**		**$ 300,000**	
Fixed Assets	$ 50,000	FULLY DEPRECIATED	$ -	
Accum. Depr.	$ (50,000)		$ -	
Net Fixed Assets	$ -		$ -	
Intangible Assets	$ -	APPRAISED	$ 1,000,000	
Other LT Assets	$ -		$ -	
Total Assets	**$ 300,000**		**$ 1,300,000**	
Liabilities				
ST Debts / Notes Payable	$ -		$ -	
Accounts Payable	$ 300,000		$ 300,000	
Accrued Expenses	$ -		$ -	
Other Current Liabilities	$ -		$ -	
Total Current Liabilities	**$ 300,000**		**$ 300,000**	
SBA Debt for Change of Ownership	$ -	NEW DEBT	$ 900,000	
SBA Debt for Working Capital	$ -	NEW DEBT?		
SBA Debt for Closing Costs	$ -	NEW DEBT?		
Total Liabilities	**$ 300,000**		**$ 1,200,000**	
Retained Earnings	$ -		$ -	
Treasury Stock	$ -	IGNORE NEGATIVE	$ -	
Total Net Worth	**$ -**		**$ 100,000**	
Total Liabilities & Net Worth	**$ 300,000**		**$ 1,300,000**	
		Equity	**$ 100,000**	
		Total Assets	**$ 1,300,000**	= 7.7%

Other SBA Rules

- Earn-outs are NOT permitted
  - Not stated in SOP, but confirmed by SBA
  - Reverse Earn Out?
- Seller note CAN be bifurcated
  - 10% Buyer down payment required
  - Buyer injection: 5%, Seller holds 15%
  - Seller note #1: 5% (fully standby for term of loan)
  - Seller note #2: 10% (payments can start on day 1)
- Seller's Involvement Post-Sale

2. The seller may not remain as an officer, director, stockholder or key employee of the business. (13 CFR §120.130) (If a short transitional period is needed, the small business may contract with the seller as a consultant for a period not to exceed 12 months including any extensions.)

  - Industry consensus: **no** seller involvement at all after 12 months.

Equipment Appraisals

- When ordering an equipment appraisal, always request both standards of value:
  - Fair Market Value
    - No time restriction to sell assets
    - FMV of equipment can be used in Business Valuation in lieu of Net Book Value
  - Orderly Liquidation Value
    - Approx. 90-120 Days and typically 65% of Fair Market Value
  - Also ask the equipment appraiser to separately allocate aggregate values of machinery/equipment and furniture/fixtures

Collateral requirements discussed on sbavalue.com

The Valuation Process

- Valuation Methods
- Liquor Store and Dental Practice
- Factors that Impact Value
- Typical Valuation Multiple Ranges

Business Valuation Basics

Standard of Values:

- Fair Market Value:
  - Hypothetical, willing/able buyer and sellers, under no compulsion to act, having reasonable knowledge of all facts, acting at arm's length
- Investment Value: (typically higher than FMV)
  - The value to a particular buyer based on individual investment requirements and potential synergies (intrinsic value)

Fair Market Value: Dry Cleaner

Investment Value: Dry Cleaner

I own three dry cleaners in the neighborhood, I'll pay you $350,000 for your business.

How is a Business Valued?

Asset approach	• Adjusted Book Value Method
Market approach	• (Similar) Transaction Method
Income approach	• Single Period Capitalization Method • Multi Period Discounted Cash Flow Method

*<u>Each</u> approach should be considered in <u>*every*</u> valuation engagement

How are Values Reconciled?

RECONCILIATION				
100% Control Interest in the Company				
Valuation Method:	**Indicated Value**		**Confidence Level**	**Weighted Estimate**
Asset Approach				
Adjusted Book Value Method	644,000			
(No Discounts or Premiums)	-			
Adjusted Value	644,000		0%	-
Market Approach				
Direct Market Data Method - Weighted Value	1,717,400			
(No Discounts or Premiums)	-			
Adjusted Value	1,717,400		60%	1,030,440
Income Approach				
Capitalization Method - Control Adjusted	1,665,000			
Less: Illiquidity Discount	(57,950)			
Adjusted Value	1,607,050		40%	642,820
Value - 100% Interest in Company			100%	1,673,260
Times Interest to be Valued				x 100%
Value Conclusion - 100% Interest in Company				1,673,260
Value Conclusion - 100% Interest in Company (Rounded)				**$ 1,670,000**

Using the Market Approach

- Market Approach is the most frequently used appraisal method for small businesses (sales less than $2 - $3 million)
  - Price / **Earnings** multiple
    - Apply a multiple to the earnings

Earnings (SDE)	$ 250,000
Price / Earnings Multiple	4
Value	$1,000,000

Using the Market Approach

- Price / **Sales** multiple
  - Apply a multiple to the sales

Sales	$ 1,000,000
Price / Sales Multiple	0.7
Value	$ 700,000

- The Price / Sales approach does not take into consideration many variable expenses that can impact the cash flow (rent, COGS, salaries, etc.), so this multiple is relied upon infrequently.

Pitfalls of Price/Revenue Multiples

Dental Practice - Scenario 1		
Revenue	**$ 1,000,000**	**100.0%**
Operating Expenses:		
Owner's Compensation (inc. tax)	150,000	15.0%
Staff Compensation (inc. tax)	290,000	29.0%
Lab Fees	70,000	7.0%
Rent	60,000	6.0%
Clinical Supplies	60,000	6.0%
Other Misc. Expenses	170,000	17.0%
Total Operating Expenses	**800,000**	**80.0%**
Net Income (EBITDA)	**$ 200,000**	**20.0%**
Add: Owner's Compensation	150,000	
Seller's Discretionary Earnings (SDE)	**$ 350,000**	**35.0%**

		Multiple	Value
Value based on SDE	$ 350,000	2.0	$ 700,000
Value based on Revenue	$ 1,000,000	0.7	$ 700,000

Pitfalls of Price/Revenue Multiples

Dental Practice - Scenario 2		
Revenue	**$ 1,000,000**	**100.0%**
Operating Expenses:		
Owner's Compensation (inc. tax)	150,000	15.0%
Staff Compensation (inc. tax)	350,000	35.0%
Lab Fees	70,000	7.0%
Rent	60,000	6.0%
Clinical Supplies	100,000	10.0%
Other Misc. Expenses	170,000	17.0%
Total Operating Expenses	**900,000**	**90.0%**
Net Income (EBITDA)	**$ 100,000**	**10.0%**
Add: Owner's Compensation	150,000	
Seller's Discretionary Earnings (SDE)	**$ 250,000**	**25.0%**

		Multiple	Value
Value based on SDE	$ 250,000	2.0	$ 500,000
Value based on Revenue	$ 1,000,000	0.7	$ 700,000

Liquor Store – LLC

Form **1065** Department of the Treasury Internal Revenue Service

U.S. Return of Partnership Income
For calendar year 2011, or tax year beginning ____________, 2011, ending ____________, 20 ____.
► See separate instructions.

OMB No. 1545-0099 **2011**

Income	1a	Merchant card and third-party payments (including amounts reported on Form(s) 1099-K). For 2011, enter -0-	1a	0		
	b	Gross receipts or sales not reported on line 1a (see instructions)	1b	2,211,481		
	c	Total. Add lines 1a and 1b	1c	2,211,481		
	d	Returns and allowances plus any other adjustments to line 1a (see instructions)	1d			
	e	Subtract line 1d from line 1c	1e	2,211,481		
	2	Cost of goods sold (attach Form 1125-A)	2	1,732,334		
	3	Gross profit. Subtract line 2 from line 1e			3	479,147
	4	Ordinary income (loss) from other partnerships, estates, and trusts (attach statement)			4	
	5	Net farm profit (loss) (attach Schedule F (Form 1040))			5	
	6	Net gain (loss) from Form 4797, Part II, line 17 (attach Form 4797)			6	
	7	Other income (loss) (attach statement) STM. 02			7	82,156
	8	**Total income (loss).** Combine lines 3 through 7			8	561,303
Deductions (see the instructions for limitations)	9	Salaries and wages (other than to partners) (less employment credits)			9	98,114
	10	Guaranteed payments to partners			10	
	11	Repairs and maintenance			11	12,432
	12	Bad debts			12	
	13	Rent			13	144,000
	14	Taxes and licenses See.ATT_PTL			14	15,166
	15	Interest			15	30,105
	16a	Depreciation (if required, attach Form 4562)	16a	28,644		
	b	Less depreciation reported on Form 1125-A and elsewhere on return	16b		16c	28,644
	17	Depletion **(Do not deduct oil and gas depletion.)**			17	
	18	Retirement plans, etc.			18	
	19	Employee benefit programs			19	
	20	Other deductions (attach statement) STM. 04			20	142,549
	21	**Total deductions.** Add the amounts shown in the far right column for lines 9 through 20			21	471,010
	22	**Ordinary business income (loss).** Subtract line 21 from line 8			22	90,293

Liquor Store – Cash Flow

Form **1065** — U.S. Return of Partnership Income — For calendar year 2011, or tax year beginning ________, 2011, ending ________, 20 ____. ► See separate instructions. OMB No. 1545-0099 — **2011**

Department of the Treasury, Internal Revenue Service

Deductions (see the instructions for limitations)

9	Salaries and wages (other than to partners) (less employment credits)		9	98,114
10	Guaranteed payments to partners		10	
11	Repairs and maintenance		11	12,432
12	Bad debts		12	
13	Rent		13	144,000
14	Taxes and licenses	See ATT PTL	14	15,166
15	Interest		15	30,105
16a	Depreciation (if required, attach Form 4562)	16a 28,644		
b	Less depreciation reported on Form 1125-A and elsewhere on return	16b	16c	28,644
17	Depletion (Do not deduct oil and gas depletion.)		17	
18	Retirement plans, etc.		18	
19	Employee benefit programs		19	
20	Other deductions (attach statement)	STM. 04	20	142,549
21	**Total deductions.** Add the amounts shown in the far right column for lines 9 through 20		21	471,010
22	**Ordinary business income (loss).** Subtract line 21 from line 8		22	90,293

Amortization $40,000

Step 1: Calculate EBITDA

EBITDA Calculation	
Net income (loss) from financials	$ 90,923
Add: Interest	$ 30,105
Add: Taxes	$ -
Add: Depreciation	$ 28,644
Add: Amortization	$ 40,000
EBITDA (unadjusted)	$ 189,672

Liquor Store – Cash Flow

Form **1065** — U.S. Return of Partnership Income — For calendar year 2011, or tax year beginning ________, 2011, ending ________, 20 ____. ► See separate instructions. OMB No. 1545-0099 — **2011**

Department of the Treasury, Internal Revenue Service

Deductions (see the instructions for limitations)

9	Salaries and wages (other than to partners) (less employment credits)		9	98,114
10	Guaranteed payments to partners		10	Officer's Comp $15,000
11	Repairs and maintenance		11	12,432
12	Bad debts		12	
13	Rent		13	144,000
14	Taxes and licenses	See ATT PTL	14	15,166
15	Interest		15	30,105
16a	Depreciation (if required, attach Form 4562)	16a 28,644		
b	Less depreciation reported on Form 1125-A and elsewhere on return	16b	16c	28,644
17	Depletion (Do not deduct oil and gas depletion.)		17	
18	Retirement plans, etc.		18	
19	Employee benefit programs		19	Owner's Heath $5,000
20	Other deductions (attach statement)	STM. 04	20	142,549
21	**Total deductions.** Add the amounts shown in the far right column for lines 9 through 20		21	471,010
22	**Ordinary business income (loss).** Subtract line 21 from line 8		22	90,293

Step 2: Calculate Normalized Seller's Discretionary Earnings

	EBITDA
+	Owner's Compensation
+	Normalizing Adjustments*
=	Normalized SDE
	**Normalizing Adjustments*
	Non-Recurring Expenses
	Non-Business Expenses
	Owner's Perks
	Rent Adjustment

Typical Add-backs

- Owner(s) compensation (over/under compensated)
- Manager's Salary (if absentee owned) or Family Salaries (supported by W2's)
- Related payroll taxes, benefits, profit sharing
- Other Discretionary expenses:
  - Spouse's Compensation (if not involved in business)
  - Personal auto
- Nonrecurring items or events:
  - Non recurring legal fees
  - Non recurring consulting fees paid to previous owner
- Unrelated income / pass through income
- Transactions with affiliate(s) (i.e. arm's-length)

Add-backs Not Generally Accepted

- Advertising / Marketing (difficult to know how much revenue was generated)
- Full Rent – If real estate is owned by the business owner, the rent must be normalized to market rates
- Adjusting expenses such as Cost of Goods Sold or Salaries to Industry (RMA) Averages
- Synergistic Add-backs – certain expenses that may change when a specific buyer takes over
- Travel Expenses and Meals/Entertainment Expenses (in most cases)

Liquor Store – Cash Flow

Form **1065** — U.S. Return of Partnership Income
For calendar year 2011, or tax year beginning ____________, 2011, ending ____________, 20 ____.
► See separate instructions.
Department of the Treasury, Internal Revenue Service — OMB No. 1545-0099 — **2011**

Deductions (see the instructions for limitations)

9	Salaries and wages (other than to partners) (less employment credits)	9	98,114	
10	Guaranteed payments to partners	10	Officer's Comp	$15,000
11	Repairs and maintenance	11	12,432	
12	Bad debts	12		
13	Rent	13	144,000	
14	Taxes and licenses ... See.ATT_PTL	14	15,166	
15	Interest	15	30,105	
16a	Depreciation (if required, attach Form 4562) — 16a: 28,644			
b	Less depreciation reported on Form 1125-A and elsewhere on return — 16b	16c	28,644	
17	Depletion (Do not deduct oil and gas depletion.)	17		
18	Retirement plans, etc.	18		
19	Employee benefit programs	19	Owner's Heath	$5,000
20	Other deductions (attach statement) ... STM. 04	20	142,549	
21	**Total deductions.** Add the amounts shown in the far right column for lines 9 through 20	21	471,010	
22	**Ordinary business income (loss).** Subtract line 21 from line 8	22	90,293	

Appraiser's Cash Flow for Liquor Store	
EBITDA	$ 189,672
Add: Owner's Compensation	$ 15,000
Add: Non-Business / Non-Recurring / Owner's "Perks"	$ 5,000
Add: Rent Paid to Affiliate Holding Company (EPC/OC)	$ 144,000
Less: Fair Market Rent	$ (100,000)
Seller's Discretionary Earnings (SDE)	$ 253,672

Sq. Feet	Gross Rent PSF
5,000	$ 20.00

Liquor Store – Cash Flow

Form **1065** — U.S. Return of Partnership Income
For calendar year 2011, or tax year beginning ____________, 2011, ending ____________, 20 ____.
► See separate instructions.
Department of the Treasury, Internal Revenue Service — OMB No. 1545-0099 — **2011**

Appraiser's Cash Flow(s)

Appraiser's Cash Flow for Liquor Store		
EBITDA	$ 189,672	
Add: Owner's Compensation	$ 15,000	
Add: Non-Business / Non-Recurring / Owner's "Perks"	$ 5,000	
Add: Rent Paid to Affiliate Holding Company (EPC/OC)	$ 144,000	
Less: Fair Market Rent	$ (100,000)	• Adjustment for market comp/rent
Seller's Discretionary Earnings (SDE)	$ 253,672	
Less: Market Replacement Salary for Owner	$ (35,000)	• Adjustment for fair market comp
Adjusted EBITDA	$ 218,672	

vs. Underwriter's Cash Flow

Cash Flow for Lenders (Underwriters)		
EBITDA	$ 189,672	
Add: Owner's Compensation	$ 15,000	• Adjustment for buyer's draw
Deduct: Buyer's Required Draw	$ (65,000)	
Add: Rent Paid to Affiliate Holding Company (EPC/OC)	$ 144,000	• No adjustment for market rent
Cash Flow Available to Service Debt	$ 283,672	

Which Multiple is Reasonable?

What is the relationship between the Price / Earnings multiple and the Rate of Return (or Return on Investment / ROI)?

- **Price / Earnings multiple of 2.0**
  2 x Earnings = 2 year payback period = 1/2 or 50% Return on Investment
- **Price / Earnings multiple of 3.0**
  3 x Earnings = 3 year payback period = 1/3 or 33% Return on Investment
- **Price / Earnings multiple of 4.0**
  4 x Earnings = 4 year payback period = 1/4 or 25% Return on Investment
- **Price / Earnings multiple of 5.0**
  5 x Earnings = 5 year payback period = 1/5 or 20% Return on Investment

Which Multiple is Reasonable for the Previous Liquor Store?

Normalized SDE (rounded)		250,000	
Chosen Price / Earnings Multiple	x	**2.0**	2 year return
Estimated Value (rule of thumb)		500,000	50% ROI
Normalized SDE (rounded)		250,000	
Chosen Price / Earnings Multiple	x	**3.0**	3 year return
Estimated Value (rule of thumb)		750,000	33% ROI
Normalized SDE (rounded)		250,000	
Chosen Price / Earnings Multiple	x	**4.0**	4 year return
Estimated Value (rule of thumb)		1,000,000	25% ROI

Factors that Influence the Multiple

- Owner's involvement
- Financial Strength
- Transferability of Revenues
- Size of Potential Buyer Pool
- Customer Concentration
- Size of Company / Revenues
- Growth Prospects
- Marketability
- Brand recognition
- Industry and company risk
- Management depth
- Employee retention
- Ease of operations
- Quality of clients
- Product mix

Which Multiple is Reasonable for the Previous Liquor Store?

Normalized SDE (rounded)		250,000	
Chosen Price / Earnings Multiple	x	**2.0**	2 year return
Estimated Value (rule of thumb)		500,000	50% ROI
Normalized SDE (rounded)		250,000	
Chosen Price / Earnings Multiple	x	**3.0**	3 year return
Estimated Value (rule of thumb)		750,000	33% ROI
Normalized SDE (rounded)		250,000	
Chosen Price / Earnings Multiple	x	**4.0**	4 year return
Estimated Value (rule of thumb)		1,000,000	25% ROI

Cash Flow – Valuations Recap (SDE)

Appraiser's Cash Flow for Liquor Store	
EBITDA	$ 189,672
Add: Owner's Compensation	$ 15,000
Add: Non-Business / Non-Recurring / Owner's "Perks"	$ 5,000
Add: Rent Paid to Affiliate Holding Company (EPC/OC)	$ 144,000
Less: Fair Market Rent	$ (100,000)
Seller's Discretionary Earnings (SDE)	$ 253,672

Dentist Practice – S Corp

Form **1120S** — Department of the Treasury, Internal Revenue Service (77)

U.S. Income Tax Return for an S Corporation

▶ Do not file this form unless the corporation has filed or is attaching Form 2553 to elect to be an S corporation.

EXTENSION GRANTED TO 09/17/12

OMB No. 1545-0130 — **2011**

Caution: *Include only trade or business income and expenses on lines 1a through 21. See the instructions for more information.*

Income	1 a	Merchant card and third-party payment. For 2011, enter -0- 0. **b** Gross receipts or sales not reported on line 1a 1,328,318. **c** Total. Add lines 1a and 1b ▶	1c	1,328,318.
	d	Returns and allowances plus any other adjustments (see instrs.) **e** Subtract line 1d from line 1c ▶	1e	1,328,318.
	2	Cost of goods sold (attach Form 1125-A)	2	
	3	Gross profit. Subtract line 2 from line 1e	3	1,328,318.
	4	Net gain (loss) from Form 4797, Part II, line 17 *(attach Form 4797)*	4	
	5	Other income (loss) *(attach statement)* STATEMENT 1	5	6,842.
	6	**Total income (loss).** Add lines 3 through 5 ▶	6	1,335,160.
Deductions (See instructions for limitations)	7	Compensation of officers STATEMENT 2	7	185,150.
	8	Salaries and wages (less employment credits)	8	309,176.
	9	Repairs and maintenance	9	2,081.
	10	Bad debts	10	
	11	Rents	11	85,804.
	12	Taxes and licenses STATEMENT 3	12	39,161.
	13	Interest	13	63,773.
	14	Depreciation not claimed on Form 1125-A or elsewhere on return *(attach Form 4562)*	14	14,790.
	15	Depletion **(Do not deduct oil and gas depletion.)**	15	
	16	Advertising	16	10,895.
	17	Pension, profit-sharing, etc., plans	17	7,024.
	18	Employee benefit programs	18	Amortization $50,000
	19	Other deductions *(attach statement)* STATEMENT 4	19	450,736.
	20	**Total deductions.** Add lines 7 through 19 ▶	20	1,168,590.
	21	**Ordinary business income (loss).** Subtract line 20 from line 6	21	166,570.

Dentist Practice – S Corp

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			16	10,895.
			17	7,024.
			18	Amortization $50,000
			19	450,736.
			20	1,168,590.
			21	166,570.

EBITDA Calculation	
Net income (loss) from financials	$ 166,570
Add: Interest	$ 63,773
Add: Taxes	$ -
Add: Depreciation	$ 14,790
Add: Amortization	$ 50,000
EBITDA (unadjusted)	**$ 295,133**

Dentist Practice – S Corp

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			16	10,895.
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			18	Amortization $50,000
			19	450,736.
			20	1,168,590.
			21	166,570.

EBITDA (unadjusted)	**$ 295,133**

	EBITDA
+	Owner's Compensation
+	Normalizing Adjustments*
=	Normalized SDE
	**Normalizing Adjustments*
	Non-Recurring Expenses
	Non-Business Expenses
	Owner's Perks
	Rent Adjustment

Dentist Practice – S Corp

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	8	Salaries and wages (less employment credits)	8	309,176.	
	9	Repairs and maintenance	9	2,081.	
	10	Bad debts	10		Spouse's Salary - $25,000
	11	Rents	11	85,804.	
	12	Taxes and licenses STATEMENT 3	12	39,161.	
	13	Interest	13	63,773.	
	14	Depreciation not claimed on Form 1125-A or elsewhere on return *(attach Form 4562)*	14	14,790.	
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Dentist Practice – S Corp

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			18		Amortization $50,000
			19	450,736.	
			20	1,168,590.	
			21	166,570.	

Appraiser's Cash Flow for Liquor Store	
EBITDA	$ 295,133
Add: Owner's Compensation	$ 185,150
Add: Non-Business / Owner's "Perks"	$ 7,024
Less: Non-Recurring Gain on Sale (Equipment)	$ (6,842)
Add: Non-working Spouse's Salary (W2 proof)	$ 25,000
Seller's Discretionary Earnings (SDE)	$ 505,465

SDE		Sales		Margin
$505,465	/	$1,328,318	=	38.1%

Which Multiple is Reasonable for the Dentist Practice?

Normalized SDE (rounded)		500,000	
Chosen Price / Earnings Multiple	x	**1.0**	1 year return
Estimated Value (rule of thumb)		500,000	100% ROI
Normalized SDE (rounded)		500,000	
Chosen Price / Earnings Multiple	x	**2.0**	2 year return
Estimated Value (rule of thumb)		1,000,000	50% ROI
Normalized SDE (rounded)		500,000	
Chosen Price / Earnings Multiple	x	**3.0**	3 year return
Estimated Value (rule of thumb)		1,500,000	33% ROI

Factors that Influence the Multiple

- Owner's involvement
- Financial Strength
- Transferability of Revenues
- Size of Potential Buyer Pool
- Customer Concentration
- Size of Company / Revenues
- Growth Prospects

- Marketability
- Brand recognition
- Industry and company risk
- Management depth
- Employee retention
- Ease of operations
- Quality of clients
- Product mix

Which Multiple is Reasonable for the Dentist Practice?

Normalized SDE (rounded)		500,000	
Chosen Price / Earnings Multiple	x	**1.0**	1 year return
Estimated Value (rule of thumb)		500,000	100% ROI
Normalized SDE (rounded)		500,000	
Chosen Price / Earnings Multiple	x	**2.0**	2 year return
Estimated Value (rule of thumb)		1,000,000	50% ROI
Normalized SDE (rounded)		500,000	
Chosen Price / Earnings Multiple	x	**3.0**	3 year return
Estimated Value (rule of thumb)		1,500,000	33% ROI

Factors that Influence the Multiple

- **Diversification**
  - How many customers does the company have?
  - Does any one single client make up for more than 15% of the company's sales?

    -- Check the Aging AR Report
  - What percentage of sales do the top 5 customers represent?
  - Does the company have any vendors or suppliers in which they purchase more than 25% of the company's products/services?
- **Personal/Professional Goodwill**
  - If the owner of the company were to fall ill or a key employee were to leave, what effect would it have on company?

Factors that Influence the Multiple

- **Barriers of Entry**
  - Are there any licenses, patents, etc. increasing barriers to entry for a competitor to offer similar products/services?
- **Recurring Revenue**
  - Does the company have recurring revenue model? (i.e. customer contracts which guarantee steady revenue stream)?

Typical Multiples for Other Industries

- **Dentist Practice - 2.0x SDE multiple**
  - high chance of attrition if dentist sells
  - small buyer pool (for the business)
  - no brand recognition
  - no depth in management structure

- **Franchised Restaurant - 3.0 – 4.0 SDE multiple**
  - little attrition upon sale
  - large buyer pool (for the business)
  - training manuals / franchise support
  - ease of operations / ability to run absentee

Typical Multiples for Other Industries

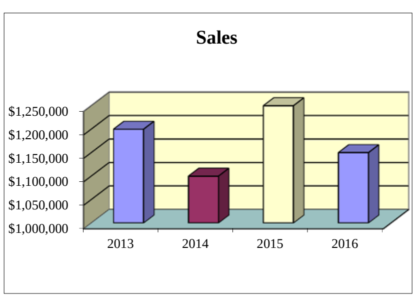
- **Insurance Agency - 3.0 – 5.0 SDE multiple**
  - recurring revenues
  - new clients must exceed annual attrition (simple enough!)
  - large buyer pool (including other insurance agencies)
  - no customer concentration

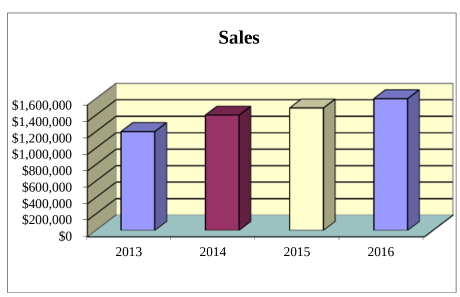
- **Home Health Care - 3.0 – 4.0 SDE multiple**
  - reliant on Medicaid vs. self-pay? Medicaid is risky…
  - large buyer pool
  - no customer concentration
  - possible large depth of management structure

Frequently Asked:

- **Question** – What year do you place most weight on?

- **Answer** – It depends on growth, volatility, anomalies, etc.





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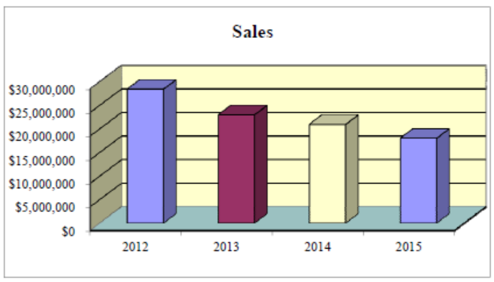

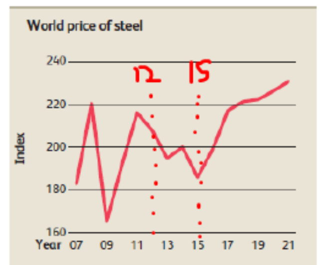

Frequently Asked:

- **Question** – What financial statements do you prefer to prepare the business valuation?

- **Answer** – The appraiser will utilize the most accurate financial statements available. Typically accrual statements are preferred. While cash accounting accurately tracks cash flow, it gives a false impression of revenue and expenses for certain industries. Therefore, accrual basis financials are preferred to show an accurate "live" overview of the company's performance. A reconciliation between the two should be requested.

Frequently Asked:

- **Question** – The buyer is purchasing three different businesses (for example restaurants), all owned by separate companies. Can you combine them into one report?

- **Answer** – Yes, as long as there is one loan and the businesses are similar in nature (or the same franchise). If there are three separate loans, you need three separate valuations.

Q&A and Contact Information

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reliant
BUSINESS VALUATION

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