

Fundamentals of Business Valuation for SBA Loans

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at 888-796-6118



Fundamentals of Business Valuation for SBA Loans

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Acknowledgement

*We would like to thank **Mike Size** for his time and providing information regarding his experiences in lending and working on SBA loans from his perspective.*

All opinions, conclusions, and/or recommendations expressed herein are those of the presenter and does not necessarily reflect the views of the SBA.



Curriculum Vitae

- Accredited Senior Appraiser (ASA) with the American Society of Appraisers (ASA)
- Certified Valuation Analyst (CVA) by the National Association of Certified Valuators and Analysts (NACVA)
- Completed 2,000+ business valuations



Key Understanding

A business valuation assists the buyer in making a determination that the seller's asking price is supported by historic operations and permits the buyer to make a reasonable return on his or her investment.



When is an independent business valuation required

- a) If the amount being financed (including any 7(a), 504, seller, or other financing) minus the appraised value of real estate and/or equipment being financed is \$250,000 or less, the lender may perform its own valuation of the business being sold, unless the lender's internal policies and procedures require an independent business valuation from a qualified source.
- b) 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 if there is a close relationship between the buyer and seller (for example, transactions between family members or business partners), the lender must obtain an independent business valuation from a qualified source.



What is a qualified source?

A “qualified source” is an individual who regularly receives compensation for business valuations and is accredited by one of the following recognized organizations:

- 1. Accredited Senior Appraiser (ASA) accredited through the American Society of Appraisers;
- 2. Certified Business Appraiser (CBA) accredited through the Institute of Business Appraisers;
- 3. Accredited in Business Valuation (ABV) accredited through the American Institute of Certified Public Accountants;
- 4. Certified Valuation Analyst (CVA) accredited through the National Association of Certified Valuation Analysts; and

A new change to the SOP in 2014 is that a CPA without one of the credentials listed above is not considered a qualified source.



Why Would You Need to Perform an SBA Valuation

- Purchase
- Restructuring



SBA approved valuation structures

- Asset Sale
- Stock Sale
- Refinance (If determined by SBA)



Asset Approach

- Determine the Book Value
- Adjusted Net Asset Method



Income Approach

- Two different types of Cash Flow Methods
 - Capitalized Earnings
 - Discounted Earnings (not encouraged)



Market Approach

- Public Comparison
- Private Comparison
 - P/Rev
 - P/EBITDA
 - P/SDE
- Prior Sales of Interest



Non-Advocacy

- No bias
- A business valuation is an advocate for Fair Market Value.



Standards of Value

- Fair Market Value (approved)
- Fair Value (not approved)
 - Used for tax purposes
- Strategic Value (not approved)



Which Financials should I use?

- Historic
 - Almost always. SBA requires that if historic financials are available, they should be used
- Projections
 - The Company has a brief history under current management
 - The Company is part of a larger entity and the sub-entity cannot be broken out.
 - Projections must be reviewed and approved by the Lender.



Typical Adjustments

- SBA valuations are typically for small loans between \$250k and \$3,000k
- Analyze Net Discretionary Cash Flow
 - Rent
 - Officer Compensation
 - Vehicle
 - Travel
 - Non-recurring Income/Expenses
 - Other



Typical Documents Include

- Three Years of business income taxes of the selling entity for the three most recent years available, or Profit and Loss statements and Balance Sheets for the selling entity for the three most recent years, if taxes are not available.
- Most current, Interim Profit and Loss statement (must be within 6 months, 3 months preferable, of valuation completion date).
- Most current, Interim Balance Sheet (must be within 3 months, 3 months preferable, of valuation completion date).
- Purchase Agreement/Deal Structure
- Approximate listing of furniture, fixtures, equipment, and sellable inventory at current market value (estimated).
- Marketing materials, photos, or other helpful documentation.
- Signed and Completed management interview/questionnaire.



Typical Business Valuation Industries

- Dentists
- Chiropractors
- Franchised Quick Service Restaurants
- Franchised Day Care
- Accountants
- Funeral Homes
- Distributors
- Auto Maintenance
- Numerous Others



Non-Operating Assets

- Commercial Real Estate
- Stocks and Bonds
- Related entities
- Excess Cash



Normalization Adjustments

Adjusted Income Statement						
Schedule 3						
		12/31/2013	12/31/2014	12/31/2015	Interim 9/30/2016	Annualized Interim 12/31/2016
Ordinary Business Income (EBT)		\$0	\$0	\$0	\$0	\$0
Normalizing Adjustments to Expenses; (Increase) Decrease	Ref.					
Billing Adjustments	1	\$0	\$0	\$0	\$0	\$0
Other Income	1	\$0	\$0	\$0	\$0	\$0
Interest	2	\$0	\$0	\$0	\$0	\$0
Owner's Salary	3	\$0	\$0	\$0	\$0	\$0
Replacement Owner's Salary at FMV	3	\$0	\$0	\$0	\$0	\$0
Rent	4					
Replacement Rent Expense at FMV	4					
Depreciation	5					
Replacement Depreciation Expense at FMV	5					
0	5					
Net Decrease (Increase) of Normalization Adjustments		\$0	\$0	\$0	\$0	\$0
Normalized EBIT		\$0	\$0	\$0	\$0	\$0
Weighting		1	2	3		0
Weighted EBIT		\$0				



What is SDE?

- Seller's Discretionary Expense (SDE)

EBIT

+ Owner's Compensation

Seller's Discretionary Expense



Multiples

Common Valuation Transaction Multiples*

Industry	Revenue Multiple	SDE Multiple
Accounting Firms	1.0x - 1.25x	2.25x - 3.0x
Assisted Living Facilities	.75x - 1.15x	varies
Child Care Facilities	.60x - .80x	3.0x
Dental Practices	.60x - 1.0x	2.0x
Hardware Stores	.40x - .50x	3.0x - 3.5x
Liquor Stores	.25x - .60x	varies
Restaurants (Franchise)	.50x - .60x	3.0x
Restaurants (Non-Franchise, Limited Service)	.30x - .40x	2.0x - 2.75x

*Multiples compiled from actual valuations completed in 2016 by Portside SBA Valuation. These multiples should be used as “Rules of Thumb” only and not solely used to determine the value of the Business.



Multiples Example – HVAC Co.

Comparable Private Transactions						
Total						
All Transactions	Revenue	SDE	Price	Price / Revenue	Price / SDE	
Low	\$754	\$75	\$80	0.02	0.65	
High	\$4,767	\$2,200	\$7,269	1.69	4.56	
Mean	\$1,916	\$365	\$883	0.41	2.12	
Median	\$1,459	\$224	\$431	0.36	2.04	
Standard Deviation	\$1,437	\$217	\$360	0.20	1.76	
Harmonic Mean	1157.10	430.62	1416.89	0.32	0.87	
	0.60	1.18	1.60	0.79	0.41	
Count	26	26	26	26	26	

Comparable Private Transactions						
Summary						
Transactions Selected	Revenue	SDE	Price	Price / Revenue	Price / SDE	
Low	\$775	\$135	\$175	0.14	1.27	
High	\$2,420	\$404	\$1,200	0.50	2.97	
Mean	\$1,401	\$205	\$467	0.32	2.14	
Median	\$1,191	\$168	\$371	0.33	2.16	
Standard Deviation	\$1,220	\$180	\$350	0.29	2.03	
Harmonic Mean	603.04	92.56	322.78	0.10	0.49	
	0.43	0.45	0.69	0.32	0.23	
Count	8	8	8	8	8	



Deal Structure

- What's included/excluded in the sale.
 - Inventory
 - Cash
 - A/R
 - Personal vehicles



Weighting your methodologies

Conclusion of Value - Part 1					
Schedule 15					
	ref	Schedule	Indicated Value	Weight	Wtd.Avg. Value
Valuation Methods Utilized:					
Capitalization of Earnings Method		9	\$500,000	50%	\$250,000
Comparable Private Transaction Method - Price-to-Revenue Multiplier		10	\$510,000	25%	\$127,500
Comparable Private Transaction Method - Price-to-SDE Multiplier		11	\$505,000	25%	\$126,250
Fair Market Value of Selected Assets					\$503,750
					(rounded)
					\$504,000



Define Intangible Assets

- Also known as Goodwill or Blue Sky
- “The value of the intangible assets is determined by either the book value as reflected on the business’s balance sheet, a separate appraisal for the particular asset, or 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.” as defined by SBA SOP 50 10 5(I).



Intangible Assets Calculation per SBA

Fair Market Value (FMV) of Operating Entity

- Less Working Capital Assets (book value or FMV)

- Less Fixed Assets (book value or FMV)

= Equals Intangible Value



Resources

- For those instances where an internal valuation can be completed, there are resources available to assist in developing multiples of value.
 - Independent Business Valuation
 - Guidance from a Business Appraiser
 - Pratts Stats
 - BizComps
 - IBA Database
 - Business Reference Guide
 - Software programs
 - Broker discussion
 - Estimate based on other sales within your bank's portfolio
 - Lender Estimate



Business Reference Guide Example

L - Rules of Thumb

Resources

Websites

- Propane Education & Research Council: www.propanecouncil.org

Trade Publications

- LP Gas Magazine: www.lpgasmagazine.com
- Butane/Propane News (BPN): www.bpnews.com
- Propane Canada: www.northernstar.ab.ca

Associations

- PERC—Propane Education & Research Council: www.propanecouncil.org
- National Propane Gas Association: www.npga.org

Liquor Stores/Package Stores (Beer, Wine & Liquor Stores)

SIC 5921-02	NAICS 445310	Number of Businesses/Units 44,988
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Rules of Thumb

- > 35 to 45 percent of annual sales plus inventory
- > 2 to 3 times SDE plus inventory
- > 2.5 to 3.5 times EBITDA
- > 3 to 3.5 times EBIT

Pricing Tips

- "Lottery Commission good indicator of area. Long hours and delivery reduce purchase price. Competition in area, parking big concerns."
- "Gross profit should be 24–39%, occupancy expense no more than 7.5%, and payroll expense 7% of revenue."
- "Stores doing less than \$1MM are trading at a lower multiple."
- "Old inventory or lack of long, reasonable lease creates an un-marketable store."
- "The % to gross is between 40–50% depending on factors such as rent, payroll, gross profit. SDE will fluctuate as well between 2.5–3.25%."
- "Retail sales are more profitable and will drive a better selling price than wholesale sales."
- "Competition in area, employee benefits, hours of operation."
- "Location, rent, and payroll expense will be the first questions asked. Gross profit is right behind them. Be prepared."
- "Number of active licenses in town. Size and appearance of stores compared to competition. Lease terms, renewal clauses, options to buy. Lottery income."
- "Liquor stores are highly desired by buyers—particularly if they include real estate. The more inventory, the greater the value. If a big box competitor is already in place, and no new locations can open up, this is a positive if the store is making a profit."

Expert Comments

Rules of Thumb - L

- "Be prepared to spend long hours in the store. Computerizing the business, if possible, will make running a successful operation much much easier."
- "Must buy existing liquor license in New Jersey. Talk of more BYOB restaurants possible."
- "Liquor store owners have a reputation in the business world for skimming cash and keeping poor books (a very easy habit for some owners to fall into when dealing with a cash-heavy business). Although credit/debit cards are being increasingly used, this affects the potential buyer because it may be impossible to determine the business's real profits. The seller may also factor unreported income into his asking price, and employees may be following the owner's lead and skimming cash as well. It may be necessary to reconstruct the financials, but the buyer must insist that the seller provide ample documentation to support the asking price. However, if the buyer is adept at keeping books, then better financials may be all the business needs to thrive more successfully than with the previous owner."

Source: <http://www.georgiandco.com/5-things-know-buying-liquor-store/>

- "Ease of replication is restricted to local licensing rules."
- "Do your due diligence on competition and what big box stores could be coming into your geographic area that could impact business."
- "Good liquor businesses are in high demand. Far more buyers than sellers."
- "Work with the seller to verify sales. Pay attention to details; do not try to reinvent the wheel."
- "Location is very important for the businesses success. In addition, multiple locations, allowing for larger case quantity purchases, will provide a better pricing and profit model for an owner. Thus, a buyer should provide for ongoing working capital to operate the store in order to take advantage of quantity case pricing. This is important to the success and ongoing survival of the store, particularly if there is a large-volume store close by, which is viewed as a competitor. Margins are shrinking in the industry at both the retail and wholesale levels. Hence, many small stores are struggling to survive, due to their occupancy cost being high, in relation to both their sales and margins. The lower margins drive the cost of occupancy up, which cannot be adjusted, when the owner is locked into a specific lease period. Hence, we are seeing many small operators, at best, buying a job. When they get into the business, they overlook the need for additional working capital and potential negative cash flow for an extended period of time, when starting a store, from 'scratch'."

Benchmark Data

Statistics (Beer, Wine & Liquor Stores)

Number of Establishments	44,988
Average Profit Margin	2.5%
Revenue per Employee	\$290,100
Average Number of Employees	3.7
Average Wages per Employee	\$20,451

Products and Services Segmentation

Distilled spirits, brandies and liqueurs	32.9%
Wine	32.3%
Beer	28.1%
Other	6.7%

When in doubt

- Contact the Lender Relations Specialist at your SBA District Office –
<https://www.sba.gov/tools/local-assistance/districtoffices>
- Contact Mike Size, Portside SBA Valuation, at (406)493-1651 or mike@portsidesba.com

