

How To Determine The Selling Price For A Brokerage Firm

By Joseph P. Klock

This feature article is a sequel to "Thoughts For All Those Planning On Selling Their Company" which was published in the September/October 1997 issue of this publication.

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Standard appraisal principles dictate that the fair market value of something is determined by what a well informed buyer will pay and a well informed seller will accept when both are willing participants and are operating without undue pressure. This assumes a mutual objectivity on both sides of the transaction, which happenstance is rare when the sale of a brokerage company is involved, since price is invariably influenced by subjective feelings on both sides of the bargaining table.

The two-part truth is that:

- 1.) Buyers will pay whatever they have to pay to get what they want, if they're sure they can't get it (or duplicate it) for less money and/or on better terms; and
- 2.) Sellers will accept the best offer obtainable from the best buyer available provided they're sure they can't do better; and the acceptable price can be skewed either way by the strength of either party's motivation.

With those modifying qualifications, we offer the following unscientific laundry list of the elements that might figure into the value of a real estate brokerage operation:

Cash transferred at closing:

Likely to be minimal, except in the bailout of a faltering enterprise.

Receivables:

Could include anticipated income from pending transactions, deferred commissions and notes or accounts receivable. If the rights to any or all such assets are retained by the seller, the price can be reduced accordingly; if assigned to the buyer, they must be discounted according to the estimated certainty of their future receipt.

Future commissions on current listings:

These figures should be discounted if payment is to be cash at closing, due to the substantial uncertainty of yield. An "if-and-when sold" provision mitigates this problem, with a percentage interest in each listing commission assigned to the sellers.

Ancillary operations:

Ancillary operations, such as property management, mortgage brokerage, development companies, insurance agencies and title/escrow companies, need to be evaluated separately, in accordance with the customs of each activity. They are often either excluded from the transaction and retained by the sellers, or spun off by the buyers after closing.

Furniture, fixtures, equipment and other physical assets:

Value can be based on cost, less depreciation (book value), market value (determined by appraisal) or a negotiated combination of the two. Book value is least likely to be used on items that have been written off to a level below their fair market value, or if they are obsolete or duplicative of similar items already in use by the buyer.

Real estate owned:

Most often, such assets are "taken off the table" and converted to leases from sellers to buyers. An exception might be a situation wherein the seller wants to maximize the cash proceeds from the transaction. (If the seller doesn't wish to buy the real estate, a third party purchaser/lessor can be located to fill the bill.)

Leaseholds:

Leaseholds can be of value if they are favorable in the light of current market conditions; e.g., when the rental value of an outstanding location has escalated far beyond the payment specified in the lease. Conversely, an unfavorable lease can be a debit in the final tally.

Contra-Assets:

Obviously, deductions must be made for accrued expenses, assumed debts and other liabilities at closing.

GOODWILL: AN ASSET LESS EASILY MEASURED

Here's a sticky wicket if there ever was one! Sellers are inclined to ascribe lofty numbers to the value of the selling firm's name, customer base, sales team, support staff, competitive position, momentum and past track record. Unfortunately, the value of all these factors tends to erode in varying degrees and at unpredictable rates, beginning at the moment of closing. Among other things, the loyalty, hence retention, of sales associates and employees cannot automatically be transferred to new ownership.

Sophisticated buyers can be guided by past experience, but all others are batting around in a fog of subjectivity, ignorance and pure guesstimation. This is yet another area wherein the proof of the pudding is in the eating (or starving) during an indeterminate period following the transfer of ownership.

In cases where no agreement can be reached, a compromise might be assigning to the seller an arbitrary percentage of future "company dollars" (income after co-broker and sales associate commissions and franchise fees have been paid), with such percentage diminishing over an agreed number of future years. There comes a time when even the most powerful brand identity fades from public recognition. Caution to sellers in such arrangements: A change by the buyer to a more liberal division of commissions and/or costlier franchise services would adversely affect the future income stream.

AN ALTERNATE METHODOLOGY

Less frequently used, but practical when both buyers and sellers are stable and sophisticated practitioners, is an agreed multiple of average gross income or company dollars in the recent past, apart from the "hard" asset values discussed above.

A variation of this is capitalization of the EBIT – earnings before interest and taxes, but after operating expenses. Under this method, a "stabilized net income stream" is agreed upon and this annual figure is divided by a capitalization rate calculated to reflect both a return on and a return of the buyer's investment. Experts estimate that this cap rate should be between 35% and 50%, often making this the least attractive (and understandable) method for the average FSBOB.

To say the least, capping the EBIT is not a game for beginners!

SOME GENERAL OBSERVATIONS

In establishing values, by any of the methods discussed here, "expert" opinions are as available as the newest practitioner and the saltiest veteran, but genuine experts are precious few in number.

Absent the availability (and affordability) of such an expert, each party might select a well-informed, disinterested representative, with these two agreeing on a third arbiter. That dispassionate troika could then sift through both the facts and fancies involved in the negotiations and come up with a suggested framework for agreement.

Whatever is discussed (and before anything is decided), the tax and legal advisers of both parties should be consulted, particularly with respect to the future implications of deferred payments, goodwill, non-compete agreements, reserves, contingent liabilities and a whole host of ghosts that can spring up months, or even years, after the final handshake at the closing table.

When carefully crafted, the sale of a brokerage operation should end with all participants feeling they didn't do quite as well as they might have hoped, but paying no more than they had to give and receiving no less than they had to take in order for both parties to get what they wanted.

In such happy endings, the terms on which they settled constitute the only true definition of fair market value.