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What Is Your Company Worth?

There are sound reasons for determining the value of your real estate office.

By Robert Martin/Grand Prairie
Real Estate Specialists
TEXAS REALTOR® Committee

Much of a broker-owner's time is spent answering questions concerning value. However, when it comes to valuing the broker's own business, many agency owners are bewildered.

Why should the owner be concerned about brokerage value? Opportunity or disaster are the principal reasons for valuing a brokerage business. Retirement, taking a new partner, selling shares in the firm, or merging with another brokerage can be classed as opportunity. In such events, the agency's worth is a significant question.

Disaster is a more ominous category. Dissolution, death, and divorce are the three "Ds" of business disaster. Thus, agency value becomes a critical issue and demands an immediate resolution.

Also, it is helpful for management to understand the factors that contribute to business value.

What is a business evaluation? REALTORS® know that value is the inherent quality that makes a property useful and desirable. Brokerage buyers and sellers must also understand the concept of "economic value." Economic valuation is a survey of the monetary benefits that accumulate to a brokerage owner.

Thus, business appraisal measures the economic benefit that accrues to the brokerage owner and then estimates the price those benefits could command in the marketplace.

The valuation process

REALTORS® know that determining a property's appraised value is only a starting point in the selling process. Appraising seems to be an exact process to the unsophisticated, but a REALTOR® knows that an appraisal provides only an opinion of value--not an absolutely dependable prediction of selling price.

When valuing a brokerage, business appraisers usually survey the economic market conditions and isolate unique brokerage characteristics. Examples are market strengths, competition, and economic environmental conditions that diminish or increase brokerage value. The property mix in the market area, available financing, lease rates, and selling price trends influence market strength and agency value.

Some elements of brokerage success are uncontrollable. Business appraisers understand that no

single broker can influence interest rates, housing policies, unemployment, or local ordinances, factors which impact real property demand and eventually the value of a business,

After reviewing general economic conditions, a business appraiser examines the special features of the brokerage. Real estate appraisal assumes that two different but similar properties should sell for similar prices, an appraisal principal known as substitution. This is where real estate and business property appraisal differ.

It is difficult to determine quantifiable similarities between brokerage operations. Two brokerages can have a similar number of agents, location, and advertising lineage but still differ in value. Thus, proper business appraisal technique demands a review of unique characteristics.

When valuing a brokerage, an appraiser usually considers the following factors: physical assets of the firm; the amount of risk found in the business; the past earnings of the firm; and brokerage goodwill.

Physical assets

Brokerage assets include current assets and fixed assets. Current assets are cash or things that can be turned quickly into cash. Current assets generally do not contribute to the value of the business, because they are usually retained by the current owner when the business is sold.

Business property that is tangible, transferable, and necessary to business operation is a fixed asset. Furniture, fixtures, libraries, and computer hardware and software are fixed assets.

Accurate valuation of fixed assets cannot be exaggerated. Buyers and sellers normally consider the value of a brokerage to be at least equal to the market value of the firm's total fixed assets. Thus, when a brokerage changes hands, the market value of the fixed assets become a "benchmark" value.

To determine the value of the fixed assets, the owner should carefully inventory all of the brokerage's tangible assets and then place a market cost on each asset. A specialist in equipment valuation might be needed.

Cautionary measures

The brokerage owner should not accept the accountant's depreciated book value of the assets as reported on the firm's balance sheet. Book value, an accounting term, doesn't describe any kind of worth or value in financial terms but represents the original cost of the asset minus any taxable depreciation applied against the item.

Book value is normally lower than the replacement cost of the asset, and it is important that all fixed assets be valued at "market" rather than at "book" value.

Determining risk

In this context risk is the probability that the actual brokerage performance will not meet new owner's expectations. Generally, the higher the risk, the less the brokerage will be worth.

One dependable technique to quantify business risk is called the Band of Investment Method. The

Band of Investment formula combines a market-determined cost of capital with an expected return of investment to the owner.

Assume a buyer can borrow 25% of the money needed to purchase the brokerage from a bank at 12% interest. The remaining 75% of the necessary business investment must come from the owner. The owner's investment is called "business" equity.

The owner has determined that the cost of these funds is 10.5%. This equity rate was determined by subtracting 1.5% from the current bank interest rate. Of course, an owner would like a greater return, but if the market lending rate is 12%, there is little likelihood of a private investor getting a greater total return.

Additionally, an owner wants a return of invested capital over a reasonable period of time. In short, the investment should return the original amount of money used to buy the business in order to make other investments.

Earnings

Potential buyers, concerned with the profit level of the business, should understand the definition of profit. If the brokerage is operated as a sole proprietorship or partnership, then pre-tax profits are significant. In contrast, post-tax earnings are the measurement if the brokerage operates as a corporation.

An examination of the brokerage's income statements (also known as a profit and loss statement) provides vital information about the earning history of the firm. Trends in revenues, expenses, and profits are determined from these business records. Income statements (or verified tax returns) for a period of three to five years are usually sufficient.

Discretionary cash flow

Potential purchasers are most interested in owner's discretionary cash flow (ODCF), a combination of net operating income, owner compensation, and annual depreciation deductions.

Generally, the level of ODCF provides the most important earnings information because it is an indicator of the available cash to retire debt, return investment to the owner, purchase new equipment, provide operating funds, and distribute income to the owner.

From the data of three years of records, an expected performance statement can be constructed. An expected performance statement represents the past financial history of the brokerage adjusted for market gyrations.

The valuation tool

The excess-earning method, a popular tool used to value businesses, assumes that goodwill which arises from the skills, special work habits of the owner and use of company assets is a residual business benefit.

The excess-earnings approach is a step-by-step procedure:

1. Determine the value of the fixed assets of the brokerage by multiplying the fixed-assets value by

the cost of capital. The result is a reasonable return on assets.

2. Determine the normalized owner's discretionary cash flow (ODCF) by subtracting the return on assets from the ODCF. The result is the amount allocated to "goodwill."

3. Divide the result found in step 2 by the predetermined risk rate. The result is the value of the goodwill found in the firm.

4. Add the value of the fixed assets (step 1) to the value of the goodwill. This results in the gross value of the firm.

5. Subtract all appropriate business debt. The result is the net value of the brokerage.

Goodwill

Goodwill varies from brokerage to brokerage and has been defined as the amount of the business-purchase price over and above the value of tangible assets and net of the liabilities of the business.

Buyers and sellers disagree. To the seller, goodwill is a valuable asset that demands a premium payment, whereas to the buyer, goodwill is an intangible and seemingly worthless item.

The market value of goodwill is negotiable. Such negotiations will usually center on the following facts: Goodwill is not a unitary asset. Goodwill can be divided into two types: marketable and non-marketable goodwill.

Marketable goodwill can be sold to a buyer. Location of the brokerage, methods of operation, nature and duration of the brokerage, quality and quantity of the listing inventory, and competitive activity are factors that influence the presence of marketable goodwill.

The willingness of the seller to enter into a non-compete contract and/or personal services contract greatly affects the price received for goodwill.

Non-marketable goodwill includes the work habits of the broker, community contracts, broker experience and education, and special relationships with independent contractors, employees, and clients, personal characteristics which cannot be transferred.

Buyers should not include non-marketable goodwill in the final purchase price. Owners should not include the nonmarketable value in the final value in matters such as divorce or tax settlements.

Quantifying is difficult. Attaching a monetary value to goodwill should be done only when a specific brokerage feature can be directly related to the expectations of future earnings.

To value his own business, a broker-owner should have some personal knowledge of the business appraisal process even if he plans to rely on an expert appraiser. If the buyer and seller are to receive an outcome "fair" to all parties, much depends upon the analytical skills of the appraiser and the negotiating abilities of the participants.

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