

BUSINESS EVALUATION SYSTEMS

BES Newswire

July – August, 2002 Issue
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What's in (or should be) in a Capitalization Rate?

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Most of us know that this is the essence of an appraisal and one of the most difficult aspects of the appraisal to determine and to support. I have and always will take issue with an “opinion of Value” report or a report that makes a “generalized” assumption to arrive at an appraised value that is less expensive and basically boils down to the appraisers experience or minor research to value the company to save the client money. To me this is like telling a doctor to forget all of the expensive diagnostic tests (i.e.: blood tests, x-rays, etc.) and based on his experience, just give me an idea of what is wrong with me. All of us know that, if detected in time, the majority of diseases or medical problems, can be cured. Therefore, it is ridiculous to assume this position with your doctor. Most doctors, no make that all doctors, would ask you to leave their office immediately for making a statement like that.

The same is true with a business appraisal. When you break down the important factors that comprise so many businesses, that can make or break a deal, no one factor should be left unresearched and its importance factored and weighed into the value of the business.

Realizing that capitalization rates should represent the risk associated with that kind of investment, it is not enough to just generalize a particular business in a particular industry and come up with a quick multiple of earnings (or divided by

100, become a capitalization rate percentage).

We have always looked at comparable sales to establish a range of value, but most agree that comparing businesses is extremely difficult. An example of this is that we valued a franchise that had 193 stores, almost identical with the same criteria for site selection. Stores that were in almost identical locations, operating under the same guidelines that the Franchiser established and with almost identical sales were, in most cases, not even close to the same net profits and therefore values. When using comparable sales as a sole method of valuation, although relatively a quick and easy way to perform an appraisal, is extremely difficult to support. For instance, you must support your adjustments for the size, location, date of sale and so many other factors that usually come into play that the final analysis results in almost a guess and the adjustments can rarely be supported. However, comparable sales are important, to show that your final value was within the range of comparable sales. This is why they are analyzed and reported in our appraisal report.

In previous newsletters, we have discussed in depth the Business Evaluation Systems Required Rates of Return Data Base. These rates, to me, make much more sense, as they are pure ratios of what a particular type of business is selling for in general and in a specific part of the country. These are multiples of earnings and capitalization rates that are reported to us by those people (approximately 280) who have been in the business of selling businesses for at least five years. It is very simple reporting, in that we ask, “What is the high and low rate of return for a business in this industry that

a buyer would expect before he or she will purchase”. When you think of it, it is a very pure ratio and does not necessarily need to be adjusted. Business Evaluation Systems can pull these ratios from almost any area or city in the nation and they are displayed also in our report.

However, the two methods mentioned so far in this article (Comparable Sales and Required Rates of Return) are merely a gauge as to the final value of the company. Again, like a doctor, every part of your body must be tested and reported as healthy or unhealthy depending on the ailment, before a final diagnosis can be given. This is why a “generalized diagnosis or appraisal is not only extremely dangerous, but can end up resulting in your death. In selling business, it is the same, a generalized value placed on a business can be totally wrong because all of the factors (like blood tests and x-rays) were not examined. When a buyer or you discover a very important risk factor that was overlooked, the deal does not close and you do not make money. Enough of these and your business has passed away.

Many things in the appraisal of a business must be analyzed and weighted as to the importance of risk for the company. When all of these are researched, they make up the capitalization or multiple used to make your final estimate of value. Each risk factor (and of course it depends on the type company and how important it is) needs to be researched and assigned a risk factor. Then this single factor must be weighed into the overall risk rating. Sounds difficult? It is and it should be. Many people feel like when you make things too complicated, and the client does not fully understand it, it is not a good way to set a value. My answer to this is that, do you feel the same way about an x-ray machine, a MRI scan, methodology used to determine the results of a blood test and what about an Ultra Sound? We don't understand how all of these work, but we don't care because we know that they are necessary and the doctor does. This is not

to say that the appraisal report should not be such that a client cannot follow your mathematics and arrive at the same conclusion. The problem is that most clients do not want or are prepared to go through that much mathematics and don't really care to. However, those that have advisors, who will go through the in-depth mathematical analysis, appreciate the work and thoroughness that was performed and we have testimonial after testimonial of this.

Some (and depending on the type business, can be many more) of the Risk Factors that need to be researched by industry and local analysis, internal importance (and the ability to be corrected, if necessary) and assigned a weighted value as to their overall importance for the type of business are:

Competition, management, turnover, type of business, owner financing, employees and ability to replace them if they leave, type of employees, local labor market, skills required, union strength, age of the industry, the industry market, likelihood of changes in the market for that industry, years the company has been in business, amount of consulting time the owner is willing to give, location, ability to expand, national economy, local trade area economy, desirability, leases, financing and loan ability available, complexity of the business, predictability, customers, suppliers and susceptibility for liability.

For more information about our appraisals or having us do your appraisals on a “Third Party Basis” e-mail us or give us a call and see what 25 years of experience and over 9,000 appraisals can do for you and your clients.

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