BUYING OR SELLING

AN APPRAISAL BUSINESS

BY BRAD CARTER, MAI

Are you considering buying or selling an appraisal practice? A successful appraisal practice will often operate under the same ownership for decades, so transactions of such businesses are somewhat rare–but they do occur. The most common reason for an owner to sell an appraisal business is to retire. Sales also result from the owner's decision to relocate, affiliate with a larger f rm, dissolve an unfulf lling partnership, or seek opportunities in a different f eld.

Marketability

As any good appraiser will tell you, marketability is an integral part of value. There is a relatively limited market for appraisal firms, and successfully marketing a practice could take several months or years. One reason that appraisal practices are sometimes difficult to sell is that buyers are usually limited to practicing appraisers. Obviously, this eliminates the vast majority of the investment community.

Another reason a practice may be difficult to market is that the value may be attributable to the reputation or skill of the present owner(s). If you buy an appraisal practice, what, exactly, are you buying? Usually, it is the income generated from the existing client base. Revenue generated from a client base can be significant, but is it transferable? If clients are loyal to the current owner, as opposed to the owner's company, then the income stream may end with the change in management.

A final reason that there are not ma y sales of appraisal firm is that many appraisers opt to start their own company instead of buy an existing practice.

Does the prospect of selling to a small number of qualifie buyers mean a discounted sale price? Not necessarily. Just as the seller must contend with having a shallow pool of purchasers, the purchaser is also likely to have few alternatives. It is very possible that an interested buyer may not even be able to find an available firm in a gi en market–and that often neutralizes any negotiation advantage that may seem to go to the buyer.

Selling to partners

Having an asset that is potentially valuable but with a thin market of potential buyers is an interesting dilemma. A common way this is dealt with is by selling to one or more partners. A typical scenario is that a sole proprietor will take in a partner as a long-term exit strategy. The new partner becomes familiar with the business over time, and gets to be known and (hopefully) trusted by the client base. Ideally, the eventual transition can be made without a signif cant interruption to the operation of the business.

The advantage of this arrangement is obvious: a relatively illiquid asset can be passed along. Potential risks related to partnerships include disagreements and having to share both the prof ts and the authority to make key decisions.

What's it worth?

Appraising a business is a large and complex issue. We will take a very brief look at some of the highlights related to the valuation of an appraisal f rm.

THREE APPROACHES

There are three approaches to valuing a business: the cost approach, the sales comparison approach, and the income approach. Sound familiar? The general concepts are very similar to appraising real estate–the specif cs are somewhat different.

The cost approach is based on the depreciated cost to acquire all the materials needed to open a similar business. These costs include equipment, supplies, tenant improvements, hiring and training a staff, etc. It also includes the present value of the revenue loss anticipated during the period required for the new (hypothetical) firm to match the revenue stream of the business being valued. One challenge to this is that it is extremely subjective. The amount of time it will take for a new business to match the revenue of an existing firm may be impossible to predict with enough precision for a meaningful analysis.

The principles involved in estimating the value of an appraisal firm using the sales comparison approach are essentially the same as in estimating the value of real property.

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The challenge is that there are not many sales to analyze. Moreover, many of the sales that do occur are between related parties and may not reflect arm's-length transactions.

Sales do occur, though, and business appraisers may be your best source for this type of information. First-hand research is also invaluable. If appraisal firms have been sold in your market, the buyer and/or seller may be willing to share all or part of the details with you, depending on your relationship with them. Another source of sellers is to search the archives of the Appraisal Institute's InfoExchange for listings of firms for sale. If you call the person who placed an ad a year or two ago, they'll probably have very interesting market information for you–whether or not they were successful in selling their business.

There are so many significant variables between firms, such as revenue, the type of properties appraised, the average fee, etc., that comparing sale prices alone may not be helpful or appropriate. Despite these differences, analyzing economic units of comparison such as multiples and ratios could be very helpful.

The income approach pertains to a multiple of income, which can be either net or gross. Discounted cash flow analysis is sometimes used. Most appraisal firms are small, and extreme caution is recommended in projecting revenues for a small company several years into the future.

INFLUENCES ON VALUE – TANGIBLE FACTORS

In applying any of the three approaches to value, there are both tangible and intangible factors to be considered. The tangible factors are those related to hard (physical) assets or the income stream.

Tangible factors to consider include:

- The amount of gross revenue
- The amount of net income
- Accounts receivables
- Work-in-progress
- Furniture, fixtures and equipment

Business appraisers report that sales of appraisal firms have occurred with the prices negotiated on the following basis:

- 40 to 50 percent of gross revenues
- 25 to 50 percent of gross revenue + work-in-progress + accounts receivable – liabilities
- three times earnings before interest, depreciation, taxes, and owner's compensation

Many companies operate in such a way to maximize expenses for tax purposes. In analyzing net income, use a normalized operating statement that reflects expenses that would be incurred if you were attempting to maximize profits.

For more information on sales rates, see Retirement Considerations, page 12.

INFLUENCES ON VALUE – INTANGIBLE FACTORS

The intangible factors are items that affect how much a buyer will pay for the hard assets. In appraising real estate, the income approach would reflect both the quantity and quality of income. Similarly, in estimating the value of an appraisal firm, the tangible factors are the quantity of income and the intangible factors are quality of income. Assume that appraisal firms are selling between 40 and 50 percent of gross revenue. Where should a particular firm be priced within that broad range? The answer would be determined through an analysis of the intangible factors.

Intangible factors to consider include:

- The client list. The more repeat business, the more the client list is usually worth.
- How long the firm has been established.
- The skill level of the workforce.
- The likelihood of accounts receivables being collected.
- The location of the firm (urban area vs. rural, competition in the market, etc.).
- There could be key person discount. Owners must demonstrate the transferability of their firm's goodwill.

Terms of sale

It has often been said that the seller names the price, the buyer names the terms, and the terms drive the deal. Consider the following in evaluating or negotiating sale terms:

- Appraisal firms are rarely sold for all cash; seller financing is the norm.
- Performance standards are very common. Under such an arrangement the sale price may be determined all or in part on revenue after the sale.
- Owners are sometimes asked (or required) to remain involved in the company for a specified period of time after the sale to ease the transfer.
- Buyers usually expect a discount on account receivables. In general, older account receivables carry a greater risk of nonpayment.
- Sellers with a high level of confidence that all or most receivables will be collected may want to exclude them from the sale.

Summary

Buying or selling an appraisal practice can be a long and difficult process, but can also be very rewarding. If you have the patience to wait for a deal that makes sense, and apply the tips above, there should be ample opportunities for both buyers and sellers. ■

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