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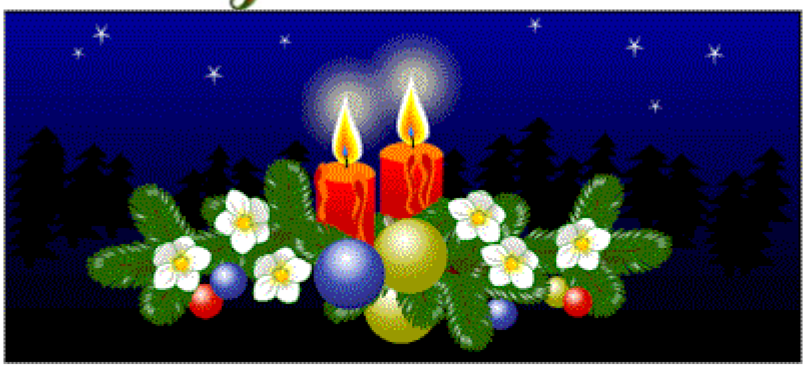
Tough Ones - Valuing Very Small Businesses

Merry Christmas!



Among the toughest valuation assignments of all are being asked to value a very small business. Many of these very small businesses have poor financial records – often not even QuickBooks financials and rarely a balance sheet that makes any sense. It is not unusual to find business and personal expenses comingled, real estate owned by the business owner and not leased to the business, some revenue (cash generally) not be reported, and a host of other issues.

Most often these very small businesses are being valued for a divorce and occasionally for a sale. When they are being valued for a divorce, generally the spouse most involved in the business is not very helpful, i.e. they are not interested in answering questions or will attempt to mislead the appraiser; typically trying to reduce the value to minimize the business's impact on the property settlement. I am constantly amazed at how quickly a business owner's outlook on the future can change depending on the purpose and use of an appraisal. If selling the business, everything looks great and the future is bright; if getting divorced, the same business is in terrible shape and will likely go into bankruptcy next week. Somewhere in between is the likely answer.

Two recent examples are useful in pointing out some of the issues and how they should be resolved.

First, another appraiser asked me how to deal with valuing a beauty salon in a small town. The building goes with the sale and the owner doesn't want to spend the money to have the building appraised. The business is a sole proprietorship with the owner averaging about $36,000 a year without paying herself rent.

There are a number of problems with this scenario – first, the risks associated with real property is generally much lower than that of a very small operating business. If the building is treated as an operating asset, i.e. market rent is not deducted from the income statement before valuing the business and the market value of the building added to the value of the business, the combined business and real property will typically be undervalued. This occurs because a much higher cap rate applicable to a very small business (often 20% to 30%) is used to value both the real property income stream as well as the business income stream. The assessed value of the real property could be used as a proxy for its value or the buyer and seller could agree on the value of the real property. If this is done, then a market rent could be estimated and at least the values for the real property and the business could be allocated even if they are not exact. I suggested that the appraiser point this out to the owner and get acceptance, in writing, of whatever approach is followed.

Another interesting situation I have recently encountered is the valuation for a divorce of a new auctioneer business. I am just getting started on this one and I am sure that it will be interesting. The business has been in operation for just over one year, it has no financial statements (just copies of bank statements and check registers). A key consideration for a very small business is the important question: "is the business transferrable in a sale, i.e. would anyone buy this business?" Regardless of the profitability of a very small business, especially one that depends on the skills and contacts of one individual, is the likelihood of the transferability of the business to another. If there is another key employee(s) that is (are) heavily involved in the business, then transferability is more likely, but this is unusual in very small businesses.

One of the key items that must be considered when valuing a very small business is the amount of funds available to pay the owner-manager-chief bottle washer-floor sweeper, etc. This owner's compensation or owner's discretionary earnings amount must be identified. If the business generates insufficient earnings to pay someone else to do what the owner does, it is likely that no intangible business value exists. If the converse is true, and it appears likely that a transition to another owner-manager is possible without losing much business, then some intangible business value may exist.

There are a number of methods and techniques for valuing very small businesses. Getting the right number is challenging and these assignments are not for the inexperienced appraiser. It may not take a long time to value this type of business, but some serious thought and consideration of the data must be made in order to arrive at a meaningful conclusion.

Valuations play a part in all strategic transactions, tax, and many litigation matters. For additional information or advice on a current situation, please do not hesitate to call. **We value real estate, businesses, and personal property including livestock and machinery & equipment.**

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