

Rosalie Wilson



Value Added/Farm 'Business for Sale' Valuation

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Overview

Following is a discussion on 'Business for Sale' valuation models to assist farms, value added businesses, and agricultural business planning consultants assist farms in planning for eventual farm/business transfer.

Primary questions:

How to determine the value of the business?

How to present the 'Business for Sale'?

Methodology

To develop a fair market valuation for the business, and prepare to "present a business for sale" there are five key methods to establish a business' worth in non-merger sales transactions of farm, manufacturing, commercial, and retail businesses.

1. Capitalization Rate Analysis
2. Comparables Analysis Valuation
3. Asset-Based Valuation
4. Land Use Valuation
5. "Rea Life" Valuation

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Valuation Methods

Research on traditional business valuation models was completed with advice from:
Steve Paddock at the VT Small Business Development Center
Dan Smith, Vice President of Greater Burlington Industrial Corporation, GBIC.
Lynn Silva, The Silva Group LLC

I. Capitalization Rate Analysis

Capitalization rate ('cap rate') is a measure of the ratio between:
The net operating income produced by an [asset](#) and either
....its [capital cost](#) (the original [price](#) paid to buy the asset)
....or its current [market value](#) (the price it would sell for now)

Step 1.

To develop a capitalization rate based value for the business we first need to "standardize" the operation's net income, meaning discretionary expenses on the cash flow generally included for an owners' benefit are excluded (such as owner's share of health insurance, personal auto expense, meals, travel, etc.). Depreciation and interest expense are also excluded (depreciation because it is a non-cash expense, and interest expense because it is another subjective and discretionary owner's expense). This will leave one with a standardized net income or cash flow, an objective representation of the actual income the business generates.

Step 2.

The second step is to determine a fair capitalization rate. Capitalization rates can be based on industry or regional standards, and are an indirect measure of how fast an investment will pay for itself.¹

A. Steve Paddock recommends a capitalization rate between 15-18%. Steve notes that a 15-18% capitalization rate is fairly high and is indicative of the potential for higher risk associated with a small-scale retail operation.*

B. According to Colliers International in its [Colliers North America Industrial Real Estate Highlights - 2nd Quarter 2008](#), industrial property capitalization rates in North America were averaging 7.33% in the second quarter of 2008.²

C. According to Dan Smith, the longevity of a business could lend itself to lowering the capitalization rate from what Steve mentioned as this demonstrates the business has a solid market and represents lower risk than other potential small scale retail operations.

¹ http://en.wikipedia.org/wiki/Capitalization_rate

² http://www.colliers.com/Content/Repositories/Base/Corporate/English/Market_Report_Corporate/PDFs/industrialnhighlights2q2008.pdf

Step 3.

Once one has established the standardized cash flow and identified an accepted capitalization rate, the free cash flow is divided by the capitalization rate to yield the market value (selling price) of the business.

$$\text{Cash flow} / \text{Capitalization Rate} = \text{Selling Price ('capital cost')}$$

For example, if a business produces an annual free cash flow of \$10,000, and a capitalization rate of 7% is assumed, then the asset value or sale price is \$142,857.³

If we utilize each of the suggested capitalization rates offered in A, B, and C: 15%, 7.33%, and 18% we come up with a potential reasonable range for the sale price.

At 18% capitalization rate	\$10,000/.18	the sale price would be \$55,556.
At 7.33% capitalization rate	\$10,000/.0734	the sale price would be \$136,425.
At 15% capitalization rate	\$10,000/.15	the sale price would be \$66,667.

If we use the median capitalization rate from the three rates above, the capitalization rate would be 13.44%, which would produce a sale price of \$74,405.

Based on this finding, let's assume that the average sale price for this business could be established at \$74,405.

II. Comparables Analysis Valuation

Comparables Sales Valuation looks at the price at which other similar businesses have sold recently. This method is often proven to be a poor valuation method for ag-related value added businesses because there are few comparables to utilize for data.

III. Asset-Based Valuation

The asset-based valuation methodology is the worth of the business as defined by the worth of its assets on the balance sheet. It can also include the value of intangible assets. Remember that the unique positioning and strengths of the farm or business may be important criteria in assessing a valuation for sale. When assessing potential value of assets, be sure to list the business' key strengths/unique features that may contribute to its value or desirability, for example:

Sampling of additional strengths a business may possess:

- Proximity to market
- Established demand for product
- Established presence in the market
- Established wholesale delivery routes
- Longevity- XXX years in business
- Name recognition

³ http://en.wikipedia.org/wiki/Capitalization_rate

- Market environment, such as limited competition, growing demand, etc.

Note also that it would generally be assumed that all pre-existing debt would likely be required to be paid off as part of the sales closing and thus the actual dollar value back to the seller would be the value of the tangible and intangible assets less the value of all debt service.

IV. Land Use Valuation

A fourth method to determining a value for a business is through its real estate, most notably if the real estate commands a greater value than the business itself, or if a change of use could generate more income from the property than the existing business. If the business does not own the real estate, or the lease cannot be transferred to a new owner for any intent other than the existing business model, this methodology is not pertinent.

V. "Real Life" Valuation

How to confirm an acceptable price from the seller's perspective

Lastly, one should also always conduct a "bottom up" method. What does the current owner envision as an acceptable return from the sale of the business?

To conduct this research I recommend creating a "Real Life" Valuation formula. For example, with one farm we did something like this:

The farm and family consisted of a single individual who had been farming on leased land for twenty years. The farmer felt they would be happy with a sale value of the business equivalent to what they could have saved had they worked an average hourly wage job since they began their working career.

So we created a formula like this:

Gross Income Potential Assuming \$14/hr for 40 hrs/wk for 20 years
 Minus 17% Income Tax/yr for 20 years (estimated tax bracket for \$30,000/yr)
 Equals Net Income The Farmer Would Have Generated After 20 Years
 Minus Annual Cost of Living for the past 20 years, assuming the farmer's actual average of \$30/day for a single person
 Minus Mortgage Payments on a \$200,000 30 year mortgage for 20 years (the farmer's off-farm house)
 Equals Savings Potential the Farmer Would Have Been Able to Generate over 20 Years

The result was as follows:

\$582,400	Gross Income the Single Farmer Could Have Achieved Over 20 Years
-\$99,008	17% Annual Income Tax They Would Have Paid Over 20 Years
= \$483,392	Estimated Net Income Remaining
-\$219,000	Cost of Living Over Past 20 years

-\$133,333
=\$131,059

Mortgage Payments Over Past 20 years
Savings That The Farmer Would Have Had on Hand by Now

Using this formula, \$131,059 was what the farmer would have had available for retirement by now if they had worked a “regular” job during the years they’d been farming. The farmer felt this then would be a fair price for the business, because while in business the annual income only provided sufficient net income for mortgage payments and daily cost of living. Savings for retirement was assumed would come from the eventual sale of the business. In the end, for this particular example, the farmer’s desired price came right in line with both the capitalization rate valuation, which varied from a low of \$120,000 at 18% to a high of \$290,000 at 7%, and the comparables valuation which came in at \$162,000. So the farm was able to set a price for the business that they were comfortable with, and that fell within what market valuation methods also identified as realistic.

Appendices

Appendix A

Business Assessment and Appraisal Providers

Following is partial listing of business brokers and appraisers available to assist with valuing businesses for sale in Vermont.

Steve Keller & Associates
(802) 861-4600

Doug Symmes
Dr Symmes & Association
222 Holiday Dr Ste 6
White River Junction, VT
(802) 295-9400

Lynn Silva
The Silva Group LLC
1127 North Avenue Suite 27-287
Burlington, VT 05408
lsilva@thesilvagroupvt.com
(802) 864-6200

Lynn Silva is a business broker who specializes in “Main Street” businesses- businesses with \$3-5 million in revenues or less, vs larger merger and acquisitions business ventures. She provides business valuation and consulting for businesses who are 5 years out or so from retirement. Lynn also noted she is well-networked and can help provide her clients with names for other people/services they may need such as

financial advice for what to do with the proceeds of your business sale, tax accounting, etc.

Lynn cautioned that sales of viable businesses should be treated with more confidentiality than commercial real estate sales because there is more at stake, “if your clients hear you are for sale they might wonder why and drop you as a vendor, if employees hear you are for sale they may begin to look for work elsewhere, if your suppliers hear your for sale they may put you on COD (cash on delivery) for supplies, and financial lenders may make it more difficult to access capital.”