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Essential Elements To Look For When Reviewing a Valuation

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Essential Elements

To Look For When Reviewing a Valuation

by **Neal Patel, CBA**

Business valuations compiled for SBA purposes are complex, often containing over 80 pages of financials, projections and analysis. Unfortunately, many readers are tempted to skim the summary page for the conclusion of value, and close the file. This can be a costly mistake. SBA loan officers and underwriters should familiarize themselves with the essential sections of the report, so they can quickly ascertain the business appraiser's valuation methodology and which assets and liabilities impact the final value.

The goal of this article is to point out those important sections that SBA loan officers and underwriters should focus on reviewing during an initial review. This does not mean that the reader should skip over other sections; this is intended to be a guide about which portions of the report warrant close attention. There are many important sections that I have not mentioned, so it is highly recommended that the reader reviews the report in full at least once.

Summary Page and Table of Contents

Although everyone likes a summary, the reader should treat this page as a primer for important facts to come. The reader should always skim through the table of contents to get an overview of how the report is structured and what type of flow to expect.

Introduction

In this section, the appraiser briefly describes the business, its location, corporate structure and SIC/NAICS classification. The purpose of the valuation and the name of the client are also noted. The type of report being compiled is described, depending on what appraisal standards the appraiser is bound by. This should never be a "Calculation of Value" or a "Limited Scope" report. Remember, SBA valuations should be USPAP compliant and this is the section that will state such compliance. One of the most important sections is the standard of value being appraised (fair market value or investment value). Documents that are relied upon in the valuation are listed, so the loan officer or underwriter should make sure that copies of all of these documents are received and compared against the ones in the lender's file, as per the new SBA Standard of Procedures.

Economic Analysis

Most reports will have a few pages describing the current state of the national economy, but the local economy may be just as important. Comprehensive reports analyze local demographics including traffic, income and population counts. A valuation is 'a prophecy as to the future', so the future state of the economy will have an impact on the value. Accordingly, take a look at key outlook measures such as future GDP, CPI and unemployment rates that the appraiser relied upon. The appraiser should briefly discuss how these affect the value.

Industry Analysis

The industry analysis should discuss in detail the characteristics of the industry, include the key players, market segments, products segmentation and average cost structures. This is often considered to be one of the most important sections of the report, as useful information is derived by comparing the historical and current performance of the industry with the subject business. The reader should look closely at the projected industry growth rate, as the appraiser will have to take this into consideration when creating projections.

Description of the Business

By reading this section, anyone unfamiliar with the business being appraised should be able to gain a thorough understanding of the history of the business, its product/service mix, its employee structure, competition and any other relevant information that may affect the company's value. The appraiser should also briefly describe the terms of any existing contracts, noting if the transaction is an asset or stock sale.

Financial Ratio Analysis

The appraiser should be calculating gross profit and net income ratios and comparing them to at least one industry benchmark, if not two. Profitability compared to its peers will significantly affect the business value. Depending on the business type, turnover ratios such as accounts receivable/payable turnover and collections periods should be calculated and discussed.

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Income add backs and adjustments

Normally, the lender will send a list of income adjustments to the appraiser. However, the appraiser must do his/her own research in determining the validity of these add backs, and whether there are additional add backs to consider. The most common add back is owner's compensation, and the lender usually only adjusts for the amount that is needed to sustain the new buyers' lifestyle. However, the appraiser should adjust for fair market compensation if the standard of value is fair market value. Other typical add backs are rent adjustments, health insurance expenses, automobile expenses and telephone expenses. The discretionary cash flow will have the largest impact on the value of a small business, so this section should be closely scrutinized.

Asset Approach

I recommend that this section is reviewed before any others, as it will list the assets being transferred in the sale and included in the final value. If the transaction is a stock sale, the appraiser will also include the liabilities being assumed by the buyer. The loan officer or underwriter can immediately take note of what the buyer is purchasing by taking a look at the adjusted book value table. If the value includes inventory and the inventory levels change prior to closing, an internal adjustment can be made by the lender for the difference.

Market Approach

I have authored a separate article titled "The Market Approach Done Correctly" which goes into detail about how this section should be compiled. However, when reviewing a valuation, check to see that the appraiser used all three major transaction databases: Pratt's Stats, BIZCOMPS and the IBA Database. In each database, review how many different transactions were used to calculate the final multiples, and how the appraiser explains the selection of the final multiple.

Income Approach

The income approach is a complicated valuation method, comprised of "building up" to a discount rate and then subtracting the future growth rate to arrive at the capitalization rate. Take a look to see if the components of the discount rate seem reasonable, and which income stream is being capitalized or discounted. The capitalization method should be used when the future benefit stream will *remain constant*. The discounting model should be used when the future income stream is *expected to vary*. These methods are mutually exclusive.

Final Reconciliation, Rules of Thumb and Purchase Justification

In the reconciliation section located at the end of each report, the appraiser will assign weights to each valuation method described above. This should provide a detailed explanation on why each weight was selected, as the weights will have a large impact on the final value. Business brokers often use rules of thumb to estimate asking prices, and the appraiser should compare the conclusion of value to rule of thumb values to see if the conclusion of value is reasonable based on broker data. Lastly, the purchase justification test will test the ability of the business to pay off the debt associated with the proposed SBA loan, and calculate the borrower's return on investment after taxes, principal and interest are deducted.



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About Us

Reliant Business Valuation is a leading nationwide provider of certified third party business valuations for SBA lenders. All reports comply with SBA SOP 50-10 5(C) and USPAP requirements. Call Neal Patel (Certified Business Appraiser) at any time to discuss a valuation request.

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- 5 Recent Valuation Multiples
- The Reliant "Quick Fact"
- Company Highlights

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