Goodwill in Small Service Businesses:

Negotiating a Fair Price

Michael Sack Elmaleh

Negotiating a fair price for a small service business.

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by Michael Sack Elmaleh

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First Edition

Advance Praise for Goodwill in Small Service Businesses: Negotiating a Fair Price

"The book is very well organized and tells a very clear and easy to follow story; clearly written; the examples are excellent and really help to reinforce the concepts conveyed in the book. Elmaleh does an excellent job of highlighting several shortcomings associated with current valuation techniques and does a good job of offering a very viable alternative that in my opinion overcomes many of the limitations of currently used approaches to valuation."

James J. Hoffman
Co-Editor of Journal of Business Valuation and Economic Loss Analysis,
Dean, College of Business, New Mexico State University

"In this exceptional book, Michael unravels the mysteries of valuing a small services business and explains how to use science rather than art to find out how much it is worth."

James Gross
Attorney, Author and Managing Partner of Thyden Gross and Callahan

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Abbreviations

COB: Compete or Buy

DE: Discretionary Earnings

MCA: Maximum Competitive Advantage

PA: Potential Acquirer

PV: Present Value

SC: Subject Company

Chapter One: Introduction

This book introduces new approaches to appraising the equity value of small closely held service firms. This category of business includes professional firms such as accounting, dental, chiropractic and veterinary practices. It also includes barbers, hair stylists, plumbers, and lawn and pool maintenance service providers. These firms often possess *enterprise goodwill*. This means that a large percentage of customers or clients who regularly patronize the firm under current ownership will be willing to continue patronizing the firm under new ownership at least *once*. The collection of customers of a particular firm in these sectors is referred to as the *customer base*. These customers and clients will upon the recommendation of the prior owner give the new owner the opportunity to show that they will continue to receive comparable or better levels of service, price and convenience. If the new owner can prove to be as effective as the old owner the customers and clients will continue patronizing the firm under the new ownership. The difficult question is: how much is this enterprise goodwill worth? Since enterprise goodwill is usually the largest asset these firms possess answering this question pretty much tells us the value of the firm's equity. I should note that I will use the terms "customer base" and "enterprise goodwill" interchangeably.

Chapters Two and Three describe in detail the kinds of firms that we seek to appraise and the general features of small service sector economics. In Chapters Four and Five I survey current appraisal techniques and show why they fail to develop economically sensible values for enterprise goodwill. I lay out the correct solutions to the appraisal question in Chapters Six, Seven and Eight. These chapters describe the underlying theory of enterprise goodwill value. Chapters Nine through Eleven confront the significant practical measurement problems involved in assigning a value to enterprise goodwill in specific cases. Chapter Twelve provides a case study in the application of the correct appraisal methods.

A Very Brief Outline of the Correct Appraisal Approach

The retirement of an owner of a small closely held service firm presents special challenges and an opportunity to a potential new owner. For brevity I will refer to the firm being sold as the *subject company*, or simply SC. I will refer to all potential buyers as *potential acquirers*, or simply PAs. The first challenge to a PA is to replace the current owner who usually provides significant direct and indirect service hours to the firm. The opportunity involves gaining ***immediate access*** to a group of customers or clients who under ordinary circumstances could not be induced to switch firms utilizing any economically viable means of marketing. The second challenge to any PA is to provide a comparable level of quality services at comparable prices and convenience to those customers or clients who have heeded the seller's recommendation to patronize the new owner. In other words the new owner has to keep the retained clients or customers coming back.

Almost universally only highly qualified and motivated PAs buy small closely held service firms. Among the usually small set of such PAs there is almost always a clear *optimal* PA. This is the PA who can be expected to gain and retain the largest percentage of existing customers or clients after an equity transfer while extracting the most economic benefit to themselves. I develop a metric to help identify the optimal PA which I term the Maximum Competitive Advantage ("MCA").

The key to assigning a value to enterprise goodwill is to recognize that in economic substance the equity transfer price is a negotiation of a *fair* commission or referral rate. Small service sector firms with enterprise goodwill bring their buyers immediate access to presold customers or clients. The equity price or commission rate that the PA is willing to pay for the immediate access to the seller's customers or clients is constrained by the principle of comparative advantage. The PA needs some idea about how much better off they would be if they buy the SC versus not buying it.

There are only two types of PAs of small service sector firms: (1) skilled and experienced employees; and (2) competitor firms already operating in the local market. Employee PAs need to assess the difference between what they could earn if they buy the SC and the amount of salary they could expect to earn if they stay an

employee. For the competitor firm PA the comparative advantage to assess is the difference between what they could earn if they buy the SC and the amount they could earn if they continue to simply compete with the firm. I assign special terms to these assessments of comparative advantage. For employee PAs the assessment is termed *differential compensation*. For competitor firm PAs, the assessment is termed a *Compete or Buy* (COB) forecast.

The assessments of comparative advantage do not alone determine the economically reasonable bid a PA should pay the seller of the SC. Rather they set *upper bounds* on what a reasonable bid should be. The key to developing a more specific fix on a reasonable bid is to invoke and understand *fairness* criteria that will underlie the negotiation process between the PA and the retiring owner. For the retiring owner, a fair bid reflects the fact that the ability to provide a PA with immediate access to a group of pre-sold customers or clients has resulted from the seller's past successful efforts in providing quality services at a reasonable price.

The PA enters the negotiation process with their own fairness criteria. From the PA's perspective, assuming the burdens and responsibilities of servicing the group of pre-sold customer or clients must be adequately rewarded. I call this reward a "*responsibility premium*". At the scale of the firms we are concerned with in this book, the economic rewards can take the form of additional compensation for owner labor or additional profit. Often it is difficult to separate what is profit and what is compensation so the appraisal approach offered here uses a metric termed *discretionary earnings*, or "DE." DE is the amount that the owner of a closely held retains after paying everybody else for all necessary and reasonable expenses of servicing the customer or client base.

The DE must be commensurate with the burdens assumed. The future DE must provide a sufficient reward to the buyer ***net of the price paid for the equity***. Furthermore, while the first customer or client patronizations after an equity transfer have been earned by the seller's past efforts, subsequent patronizations will occur only if the PA continues to provide quality services at reasonable prices. These considerations entail the following fairness criteria:

1. The negotiated equity price should not reflect future DE derived from customers or clients acquired *after* the acquisition date.
2. The negotiated equity price should reflect the fact that virtually all transferred customers will at a certain point stop being customers. The customer base has a finite life. The equity price must reflect the fact that future DE from transferred customers will decline over time due to attrition.
3. The equity price is, in economic substance, a commission or referral fee. Because repatronization depends upon the repetitive success of the buyer in providing quality services this referral fee should decline over time.

In negotiating a fair equity price, the optimal PA will attempt to negotiate a fair level of DE for themselves in exchange for servicing the transferred customers or clients. PAs will look to *reference* levels of DE. PA's will look to three potential sources of reference levels of DE:

1. If the optimal PA is currently an employee their current level of wages sets a minimum level of reward that the expected DE must *immediately* exceed net of the cost of the equity.
2. If the buyer is a competitor firm already operating in the SC's market, the DE after acquiring the firm, net of the cost of the equity, must exceed the DE the PA would derive if it continued to compete with the SC. The bid price for an SC's customer base should never exceed the difference between the DE the PA will derive from acquiring the firm and the DE the PA will derive by competing with the firm.
3. Within a short period of time (no more than three to seven years), the total DE extracted by the PA from the customer base, net of the cost of the equity, must rise to a level close to or in excess of the level of DE that the seller was realizing at the time of the equity transfer.

The fairness criteria steering the PA and the seller to an equity price are pretty much "baked in". They reflect deeply held values. Appraisers can have little impact on this aspect of a negotiation. The critical role of the appraiser in the negotiation process is to provide both parties realistic DE forecasts for the various options available to the seller and PA.

Forecasting Challenges

A significant part of this book is devoted to the forecasting challenges in applying the recommended appraisal approaches. Most of these issues bedevil virtually all current appraisal methods. All useful measures of value are based on the future performance of an SC. The future is uncertain: risk and variation make certainty unobtainable. Therefore, all forecasts and all measures of value must be framed in the language of probability. In developing the required forecasts I recommend the use of calibrated estimates, empirical research and computer simulation. I also argue that specific risks should be identified and quantified directly in simulation forecasts and that discounts of future income streams to present values should reflect *only* the time value of money. Adoption of these ideas will move appraisal practice from an art to an empirical science.

Who Should Read This Book?

I have written this book with a number of audiences in mind. In order of priority these are:

1. Buyers and sellers of closely held firms.
2. Business brokers.
3. Lenders who finance the acquisition of closely held firms.
4. Attorneys, accountants and judges who have to evaluate the merits of appraisal reports in various litigation settings.
5. My fellow accredited appraisers.

Buyers and sellers of closely held firms and business brokers can skip the chapters covering traditional appraisal methods without missing the main thrust of the alternative appraisal methods I recommend. However, I would advise against doing so because these chapters will educate you on the fairly significant pitfalls of relying on the most widely used currently popular appraisal methods. It is my hope that these methods will in the future become unpopular and that the methods developed here will become the standard methodology for appraising smaller service sector closely held firms.

Chapter Two: The Challenge of Appraising the Value of Small Closely Held Service Firms

- What is a Small Closely Held Service Firm?
- Which Firms Will We Study?
- Who Needs and Uses Appraisals?
- Who Performs Appraisals?

"We try to accept simple answers to complex questions because the full magnitude of the problem frightens us" [1] David Schnarch

In this chapter I outline the contours of the appraisal challenge. Closely held firms are defined. I elaborate on the kinds of closely held firms that will be studied here. I briefly describe the needs and uses of appraisals and who usually performs them.

What is a Small Closely Held Firm?

If you want to know the market value of a publicly traded company, one that is listed on a widely traded exchange like the New York Stock Exchange or NASDAQ, you simply open the business pages of a newspaper or a web based newsfeed and look at the closing trading price on a share of common stock. Multiply this price by the number of common shares outstanding and you have your answer (at least as of the close of the market on that day). [2] The task is much more daunting if you want to know the market value of a closely held firm. A closely held firm is any firm whose equity shares are not traded on a major stock exchange. There are about 30 million business firms of all sizes in the US and only a few thousand are traded on major exchanges. So most US businesses are closely held and in fact most of these are fairly small firms owned by one or just a few individuals.

Which Closely Held Firms Will We Study?

In this book I will be addressing the question of how to appraise the equity of only a subset of all closely held firms. Specifically, attention is limited to closely held firms with these characteristics:

- Revenue is derived from *services* requiring more than a minimal level of skill.
- Clients or customers utilize the services *repetitively* on a fairly predictable basis.
- Most clients or customers tend to utilize only one firm *exclusively* in the provision of these services.
- Many, if not most, firms in these service sectors operate at a *small* enough scale that active participation by ownership is required.
- If the firm were sold, a significant proportion of clients or customers would continue patronizing the firm on the recommendation of the prior owner at least once.
- The cost of starting up the business in terms of equipment and leasehold improvements is not prohibitively high as long as the business owner has the requisite skill and experience to provide the service.
- There are in each sector potential acquirers (PAs) with the requisite skill and motivation to acquire these firms and with access to the financing needed to successfully complete a transfer.

I emphasize that these firms are usually small because ordinarily they have fewer than fifty employees and gross revenue well below $10 million.[3] The most common service sectors that exhibit these characteristics include:

- Accounting and bookkeeping services
- Dental practices
- Chiropractors
- Veterinarians
- Optometrists
- Barbers and Hair Stylists
- House Cleaning Services
- Daycare Centers

- Plumbers
- Landscapers and Lawn Maintenance
- Pool Maintenance

The following table compiled from IBIS World research reports shows the most common service sectors that exhibit these characteristics along with an estimate of the total number of such businesses in the United States.[4]

Business Sector	Est. # of Businesses
Accounting and Bookkeeping Services	112,000
Barbers, Hair Stylists, Nail Salons	1,200,000
Chiropractors	69,000
Daycare Centers	900,000
Dental Practices	170,000
Primary Care Doctors	131,000
Cleaning and Janitorial Services	815,000
Landscapers and Lawn Maintenance	398,000
Plumbers	105,000
Veterinarians	38,000

The Appraisal Challenge of Enterprise Goodwill

The collection of repeat, regular customers or clients of a particular firm in these sectors is referred to as the *customer base*. Firms with repeat, regular customers who would continue to patronize the business after an ownership change are usually described as possessing *enterprise goodwill*. Enterprise goodwill has value as an intangible asset to PAs because it can give them immediate access to customers for whom they otherwise would have to directly compete.

Generally small and medium sized businesses that do not possess enterprise goodwill cannot attract buyers that would be willing to pay for anything other than the value of their firm's net tangible assets (tangible assets include cash, accounts receivables, inventory and furniture fixtures and equipment). Net tangible assets are tangible assets less the firm's liabilities. Tangible assets are relatively easy to

appraise. Assigning a value to enterprise goodwill has proven to be a more difficult challenge.

As the above table indicates there are hundreds of thousands of businesses that potentially possess enterprise goodwill. In most local markets there are also a number of PAs with the skill, experience, financial means and motivation to buy these firms to exploit the selling firm's enterprise goodwill. These combinations create the condition for active markets. In fact, I would argue these types of closely held firms are the most sought after targets for equity acquisition.[5]

Let me say at the outset that there are many other sectors within the large pool of closely held firms which possess some form of intangible asset other than, or in addition to, enterprise goodwill that make them desirable targets for equity acquisition that I will *not* be considering in this book. Many non-service businesses, for example, have prime locational advantages or exclusive territorial distribution rights that would provide immediate access to customers which otherwise would be difficult to obtain through direct competition. While it is my belief that many of the principles and methods of business appraisal that apply to service type businesses apply to these sorts of businesses as well I shall not for purposes of economy and clarity consider these cases here.

One other point need be stressed in regard to the scope of my work. *Of the many millions of closely held businesses most have no value in excess of their net tangible assets*. There are several reasons for this. First, a large percentage of closely held businesses are very small businesses that operate with very little profit or provide their owners with any significant compensation. Second, many businesses do not have repeat customers. These businesses must continually recreate their customer base. Common examples of these types of business include most attorneys, architects and construction contractors who must gain business through competitive bidding. Finally, many profitable service businesses may have repeat customers but most of these customers will be unlikely to continue patronizing the firm after the key owner employee has left. These kind of firms possess *personal* goodwill as opposed to enterprise goodwill. For example, a psychotherapist's patients may not be very willing to simply continue seeing another therapist just based on their former therapist's recommendation. Let me put my choice of the sorts of firms to study

another way. While there are certainly firms in other business sectors that possess enterprise goodwill generally only a handful of these within a sector are likely to possess this critical intangible asset. However, in the sectors included in the table above it is fair to say that most possess enterprise goodwill.

Over the years much appraisal theory and practice has been developed to determine the value of enterprise goodwill. These methods and theories are, as I outline in later chapters, deeply flawed particularly as they relate to the smaller firms that we study here. Before turning to these flawed methods I need to describe why and when appraisals are needed and who performs them.

Who Needs Business Appraisal Services?

There are several groups of people who need business appraisals:

- A skilled employee who wants to own his or her own firm. Such a PA can buy an existing business or can start a new one. In deciding which option is best the PA has to be able to assign a value to the target firm.
- Owners of firms wanting to expand their customer base. These PAs have two options: continue to compete for customers or buy up one of the competitors. A value must be assigned to the target competitor.
- An owner of a firm may want to retire from a business and want to sell it. Or sell a part of it. A business appraisal is needed to guide the seller in setting a reasonable price.

Death, divorce and taxation also can create a need for a business appraisal. If an equity interest in a closely held business is considered marital property and subject to division in a divorce proceeding the equity interest must be valued. If the equity of a closely held business is part of a decedent's taxable estate it must be valued for estate tax purposes.

Often third party financing (financing supplied by some party other than the buyer or seller) is needed to complete a sale. The lender will need to know the value of the equity interest to insure that the borrower is not over-levered and can timely pay the interest and principal on the loan.

Who Performs Business Appraisals?

There are three main professional associations that offer credentials certifying expertise in appraising closely held firms:

- National Association of Certified Valuators and Analysts
- The Business Valuation Section of the American Institute of Certified Public Accountants
- American Society of Appraisers

It is estimated that there are currently about 8,000 such credentialed professionals.[6] To receive a credential in business appraisal education, experience and testing requirements have to be met. Among the credentialing bodies there are slight differences in the extent and nature of these requirements. I believe that most of the credentialed professionals are also Certified Public Accountants. However, not all credentialed professionals are CPAs. Certainly most CPAs are not credentialed business appraisers. There are no state or federal regulatory requirements that preparers of business appraisals obtain a credential. However, to have an appraisal report accepted in a legal proceeding an appraisal credential greatly assists in meeting widely accepted legal standards of evidence. Many appraisal reports are nevertheless prepared by CPAs and non CPAs without a special credential.

A Note on the Definition of Economic Benefits

Virtually every appraisal approach currently in use as well as the new approach introduced here recognizes that the equity value of an SC is largely determined by the economic benefits the firm is expected to generate in the future. Unfortunately a reader unschooled in appraisal theory and accounting is going to confront a variety of terms describing future economic benefits with different and confusing meanings. Since these definitions play a critical role in deciding which appraisal methods make the most economic sense it is important to understand the definitions of the various measures of future economic benefits.

Revenue: Gross proceeds, income or sales before any reduction for expenses. Also referred to as gross revenue.

Gross Profit: Revenue reduced for direct expenses associated with producing income.

Net Income: Gross Profit reduced for all other expenses of operating the firm.

There are two ways to compute the above three levels of economic benefit known as the "cash" and "accrual" methods of accounting. Under cash basis accounting revenue is recorded and reflected in the accounting records and financial statements when cash is collected; expenses are recorded and reflected only when cash is paid out. Under accrual accounting, revenue is recorded and reflected when a service has been provided or a good sold whether or not cash has been received at that point. An expense is recorded and reflected when a service or a good has been received whether or not cash has been paid at that point. While accrual accounting is more complicated than cash basis accounting it is generally recognized that this basis of accounting better reflects the "true" economic performance of a firm than cash basis accounting for any given accounting period. Despite this wide acceptance much appraisal theory holds that equity value must be reflected on a cash basis and a very specialized variation at that known as "free cash flow".

Free Cash Flow: The cash available to the owner after all expenses. Free cash flow does not include any reasonable compensation paid for owner services.

EBITDA: Earnings before interest expense, taxes, depreciation and amortization.

SDE: Seller's discretionary earnings. The same as free cash flow except owner compensation is added back and not subtracted.

DE: Same as SDE except the focus of the measure is on the PAs expected discretionary earnings not the sellers.

At this point it is not necessary for the reader to memorize these terms because I will reintroduce them as needed. For now, it is enough to know that there are different measures of economic benefit and that these measures reflect different approaches to the appraisal challenge.

Chapter Notes

1. David Schnarch, *Passionate Marriage,* Henry Holt and Company, 1997, p. 191
2. It is not quite this simple because for most listed companies their common shares are widely held and represent minority ownership. When a corporate takeover or merger is contemplated often a premium is offered above the listed share price in order to assemble a controlling block of shares.
3. The SBA defines small businesses in terms of numbers of employees and/or gross revenue. Here are the upper bound thresholds for some of the types of service businesses we consider in this book:

Sector	Revenue Threshold
Accountants	$ 20.5 Million
Veterinary Services	$ 7.5 Million
Landscaping Services	$ 7.5 Million
Janitorial Services	$ 18.0 Million
Dentists	$ 7.5 Million
Chiropractors	$ 7.5 Million
Optometrists	$ 7.5 Million
Barber Shops	$ 7.5 Million
Beauty Salons	$ 7.5 Million
Nail Salons	$ 7.5 Million

4. IBIS World http://www.ibisworld.com.
5. There are business broker firms who specialize in virtually all the sectors listed in the IBIS World table.
6. This estimate was provided to me by Parnell Black, the executive director of NACVA, in a private correspondence.

Chapter Three: The Small Service Sector Economic Environment

- The Psychological Importance of the Services Rendered
- Predictable Repeat Patronization
- Exclusivity and Closeness of Customer Relationships
- Full Time Owner Participation and Discretionary Earnings
- The Ineffectiveness of Advertising
- The Importance of Referrals
- Local Competitive Market Structures
- The Pool of Unattached Customers and Population Trends
- Who's Buying? Who's Selling?

The number one thing small business needs is to get more customers.[1] Brad Smith

In order to develop a sound appraisal methodology we must understand the fundamental economics of the small service sector firm. In this chapter I describe the critical features of small service sector economics. I begin by stressing the deeply personal nature of the services rendered in the sectors we study and the implications for the relationship between the service provider and the customer or client. The importance of predictable patron repetition and the exclusivity of the relationship between the service provider and the client and customer is described. We next address how the natural constraints on local service markets and the nature of customer or client attachments lead to stable competitive balance among service firms in most markets. Finally I conclude with a description of the buyers and sellers of closely held service firms.

The Psychological Importance of the Services Rendered

As you glance at the list of service sectors that have the capacity to develop enterprise goodwill you cannot help but be struck by the deeply personal nature of the services rendered. This is no accident. One sector focusses on personal appearance and grooming (barbers and hair stylists). Another focusses on personal finances (accountants and bookkeepers). Other sectors impact our personal health

(dentists and chiropractors). Yet another impacts the health of our beloved pets (veterinarians). Some sectors pertain to the appearance and upkeep of our homes (plumbers and landscapers). It would be hard to overstate the psychological importance of these services. We want and need to find *trusted* providers of these specialized services. Trust between the service provider and his or her client or customer is established by the *repeated* rendering of quality service at prices that the client or customer deems fair. More than anything else it is this earned trust that proves to be the basis of clients' and customers' willingness to accept a service provider's recommendation for a new provider when their service provider retires. Trust generates enterprise goodwill.

The Importance of Predictable Repeat Patronization

As noted earlier every type of firm we study here provides a service that is provided repetitively. Of course different types of services have different patterns of repetition. Customers and clients of tax and accounting practices, barbers and stylists, and lawn and pool maintenance firms have very regular and predictable patterns of patronizations. Clients and customers of dentists, chiropractors, veterinarians and plumbers have less predictable patterns of patronization when looked at from the standpoint of the individual customer or client. However, with a large enough customer or client base even these types of service firms exhibit in the aggregate stable predictable annual levels of patronization. It is impossible to overstate the importance of the contribution of predictable repeat patronization to enterprise goodwill value. A PA for these types of service firms can reliably predict the DE that can be expected from a group of customers or clients. This greatly simplifies the appraisal of enterprise goodwill.

Exclusivity and Closeness of Customer and Client Relationships

A critical feature of small service firms is the exclusivity of their relationships with their customers and clients. Exclusivity refers to the fact that most customers and clients have a relationship with just *one* provider firm. This exclusivity provides a strong competitive advantage for the provider firm. The customers and clients do not have the ability to easily compare the quality, convenience and price of their current firm with another competitor firm. Most customers and clients have little

incentive or interest in shopping for another firm absent some fairly significant degree of dissatisfaction.

Because most small service firms are by definition small the owner of the firm often provides services directly to the customer or client personally. Since owners tend not to leave their position as often as employees this allows for the development of long term stable business relationships. Such stability and contact with ownership builds trust and loyalty.

Required Full Time Participation of the Owner and Discretionary Earnings

While the active participation of the owner in the provision of services is an advantage in strengthening customer and client attachment to the firm, full time participation in the management of the firm is a virtual necessity for small service sector firms. Most small firms do not operate with sufficient resources to hire independent management and provide the segregation of duties that can assure the safeguarding of firm assets and reputation. A full time owner employee is required to assure the viability of the business.

The presence of full time owner participation in the operation of the firm creates challenges in the appraisal of enterprise goodwill. As we will see in chapter Five, the widely accepted Discounted Future Cash Flow ("DFC") appraisal model assumes that equity value is driven exclusively by free cash flow. Free cash flow does not include compensation paid to full time owner employees. In the small service sectors we study this assumption is clearly wrong. PAs often acquire firms to realize greater owner compensation. This additional owner compensation does in fact drive equity value.

Often it is difficult to distinguish between owner compensation and profits (which is what free cash flow is meant to measure) and the classification can be somewhat arbitrary. The classification of payments to an owner as wage or profit may be motivated by tax minimization considerations. In the case of C corporations, compensation often includes disguised profits. With S corporations, the opposite problem arises, with compensation often disguised as profit. No owner compensation is ever recognized for tax or GAAP (Generally Accepted Accounting

Principles) purposes for proprietorships, partnerships, LLCs and LLPs. Because of these classification problems, business brokers use a metric known as Sellers Discretionary Earnings ("SDE") or sometimes just Discretionary Earnings or ("DE").

DE is a measure of all cash flows that an SC generates for its owner or owners whether they are classified as wages, distributions or profits. An emphasis is placed on the term "discretionary". It is understood that there is an amount of expenses that must first be paid to third parties including all variable and fixed expenses in order to operate the business. Subtracting these non-discretionary expenses from total revenue leaves a fairly reliable measure of the benefits that are available to the owner. Using this DE measure is an effective way to eliminate some of the arbitrary tax motivated and GAAP classification issues just mentioned. For this reason I believe that DE is a good metric for measuring the required additional economic benefits required by PAs. In utilizing the DE measure four caveats are in order.

First, often expenditures for equipment, furniture and machinery are deemed to be discretionary. I believe that unless there is evidence that the SC is mismanaging its capital budget, such outlays should not be so treated. Given that these outlays can be significant and that they benefit multiple periods, they should not be treated as a non-discretionary period expense either. Rather an allowance for depreciation should be treated as a non-discretionary expense as long as it realistically represents a fair allocation of cost over the asset's useful life. Often the default for computing DE is to add back the depreciation shown on the books and subtract any fixed asset additions. Since fixed asset additions are needed to operate a business, this is not a good practice.

A second caveat concerns what appraisers term "normalizations." Often owners receive distributions that are disguised as expenses. This is done to reduce income and payroll taxes. Typical examples include deductions for automobile, travel, entertainment and meals that serve no business purpose. Another tax avoidance technique is the placement of low tax bracket relatives such as children on the payroll when they provide no significant or economically necessary labor. Yet another example involves SC owners charging their firm above market rents on separately owned land and buildings leased to the SC. Since these practices occur frequently, a normalization process is required on the part of the appraiser to adjust

these expenses to levels that reflect only economically necessary levels. This normalization process is also needed to derive a meaningful measure of DE.

A third issue involves the basis of accounting, cash or accrual, used to measure the DE. Much appraisal theory and practice stresses cash basis over accrual measures. Since it is widely recognized that accrual basis accounting more completely captures the underlying economic performance of a business it is to be preferred over cash basis measures. The issue is somewhat mooted by the fact that most small service sector firms with enterprise goodwill do not sell inventory. Some of these service businesses however do have significant accounts receivable such as accounting firms and dental practices. For most well managed practices the quick collection of most receivables is not problematic. Therefore accrual basis measures should not greatly differ from cash basis ones measured over several years.

Finally, as I recommend the metric in the appraisal methods described in this book, DE is a relative and not absolute property of an SC. DE will vary based on the degree of fixed overhead the PA will incur and the degree to which the PA will provide services directly to customers and clients. The general rules are: the higher the fixed expense burden the lower the DE, and the greater the degree of owner involvement in service provision the higher the DE. PAs of different sizes will usually realize different DE rates from acquiring the same SC.

Gaining New Customers and Clients through Marketing

PAs of small service sector firms always have an alternative to gaining immediate access to new customers or clients: they can compete for them. However, it is a fundamental feature of these sector markets that competing for customers through direct marketing is difficult and generally not cost effective. Most firms in these sectors realize this and the percentage of total revenue spent on advertising and marketing reflects this reality.

Here is a table developed from the *Almanac of Business and Industrial Financial Ratios*[2] showing advertising expense as a percentage of total revenue for some selected sectors:

Advertising Expenses as a Percentage of Sales	
Sector	%
Furniture Stores	3.8
Hardware Stores	1.6
Food and Drink	2.6
Accounting	1.1
Dentists	1.0
Plumbing	0.6
Auto Repair	1.5

The first three sectors are non-service sectors without exclusive relationships to their customers. They average 2.7 percent of gross revenue spent on advertising. The last four sectors listed are service based and average just 1 percent of gross revenue spent on advertising. There are two main reasons for the ineffectiveness of advertising in service sectors. First, quality usually trumps price and convenience as the key factors in customers' and clients' choice of a service firm. Advertising lower prices, more convenient hours or better locations are less salient to customers of a service firm than to the customers of, say, a grocery store. Second, as indicated above smaller service sector firms have the ability to develop long lasting and strong relationships with their customers and clients. Strongly satisfied customers or clients rarely pay much attention to advertising from firms competing with their preferred service provider. For these reasons smaller service firms have to rely primarily on referrals as a source of potential growth.

The Importance of Customer and Client Referrals

Because advertising is largely ineffective, the key to finding new customers and clients in the personal service sectors lies in referrals from existing clients and customers. Such referrals will usually trump any other form of marketing for the firms we study. For any sector and firms within the sector there will be characteristic rates of referral. However, no matter what the specific rate, it is absolutely true that the more customers or clients the firm serves the greater the number of referrals the firm can expect in the future. This makes buying a closely held firm with a transferrable customer base a very good marketing strategy to gain new customers

and clients. The equity buyer not only obtains the customers that exist at the time of the equity transfer but also develops access to new customers or clients through future referrals. Of course the new owner must maintain or improve upon the level of quality, convenience and price of the seller.

The nature of referrals has changed with the advent of the internet and social media. It is no longer necessary for the referral source to know the person who is using their recommendation. Today a relatively new start-up has the ability to acquire positive YELP reviews. This levels the playing field somewhat in that a new start up can be in as good a competitive position as a more established firm.

Local Competitive Market Structure

Local service sector markets are subject to important constraints that limit the number of viable competitive firms. First, all such markets are geographically constrained. Most customers and clients will travel only so far to their service provider. Even if the service is done in the customer's home the provider firm is not likely to be located too far from the customer. Second, within the geographic boundary of the local market there is at any one given time a fixed total of gross revenue that can be extracted from the local population for the relevant service. This amount is based on population size and the percentage of the population that utilizes the services. Third, each service sector has evolved an economically efficient scale of operation which limits the number of viable firms that can compete in any local market. All of these factors lead to stable competitive markets where it becomes difficult for any one competitor to dominate other competitors. Very importantly in most local markets building a new market presence without acquiring one or more existing firm is a slow process. The exception to this occurs when a local market is undergoing significant population growth and/or there is a high population mobility rate.

The Pool of Unattached Customers and Population Trends

In most local service sector markets, the competition among firms focuses on those customers not already strongly attached to one competitor. The size of this

customer pool certainly varies from market to market. There are three factors that determine the size of the unattached customer pool:

- The rate new customers move into the area
- The percentage of new customers who utilize the service
- The number of dissatisfied customers

In the service sectors which concern us, the latter two factors are not likely to vary greatly from local market to local market. For any given area with a given demographic profile the percentage of the population or households that utilize say, tax preparers, is not going to differ much. A similar statement applies to the percentage of dissatisfied customers. In the small service sectors this percentage is usually fairly low. The key variable that *is* subject to significant variation is the *mobility* rate which describes the number of new customers moving into the local market.

The mobility rate measures how quickly a given population turns over. Before delving into these measures, consider what we are measuring and why the mobility rate is so important to the competitive structure of a given local service market. There are only three demographic possibilities for any given local market:

- The population is stable: the number of people moving in is balanced by the number of people dying or moving out.
- The population is declining: the number of people moving in is less than the number dying or moving out.
- The population is increasing: the number of people moving in exceeds the number of dying or moving out.

The Stable Population Competitive Dynamics

It's not hard to figure out the general impact of these differing demographic scenarios on a particular competitor firm in the local market. In the stable population setting one would expect that the overall attrition rate over the entire market would be pretty closely balanced by the new arrivals. The attrition rate is the rate at which a service firm loses customers and clients. In aggregate the service

sector should be serving the same total number of customers over time. As long as the number of competitors remains fixed and each competitor has roughly the same ability to acquire its share of new arrivals we would expect that the size of each competitor's customer base would remain stable.

But we must be careful here. In some sectors, for some firms, there may be significant age differences between customer bases. One firm's customer base may be younger or older than another's customer base. All other things being equal the firm with the older customer base will experience a higher attrition rate than another firm *and* their share of the new replacement customers may not be sufficient to offset the losses.

The Declining Population Competitive Dynamics

The severity and the pace of population decline will of course impact the local competitive market. A rapid and steep decline will likely push weaker competitor firms out of the market. As long as the ultimate decline is not catastrophic the competitive market will survive with fewer viable firms. While population decline is in itself important, the *composition* of the population in decline often changes with more affluent residents leaving at higher rates than poorer residents. So in such a demographic scenario not only will the total pool of customers shrink but the ability and willingness to pay for services among those remaining may decline relative to the customers who are leaving.

The Increasing Population Competitive Dynamics

Local market population can also increase. If the pool of new customers is growing and the number of existing competitor firms stays constant these firms must increase their capacity to service customers or cede some or all of the expanding pool of new customers to new competitor firms. With rapid population growth the number of competitor firms usually rises and so it is likely that the number of customers served by any particular competitor is not likely to change significantly.

One point cannot be stressed enough. Given that local markets are geographically constrained population growth cannot continue *forever*. At a certain point the physical resources and infrastructure of the local area will reach a capacity and no further growth is possible. It is critical for firms to recognize that the size of the pool of unattached customers cannot continue to grow at a rapid rate without limit. The prudent and realistic assumption for small service sector firms is to aim for a sustainable levels of customers consonant with their capacity to serve them. This is in fact how most successful firms operate in these markets. Most firms will not experience significant rates of growth beyond the first few years of operation. When population growth is small or non-existent, rates of customer growth will be small in aggregate over the entire market. When there is rapid growth, most smaller firms will cede the growth to new competitors or those few existing competitors willing to expand their operating scale. The key take away is that most successful small competitor firms will seek an equilibrium level of operation where the level of growth is just sufficient to offset the natural level of customer loss.

Who's Selling and Why?

In most local service sector markets there are only a limited number of economically viable competitors. Most of these competitors gain new customers gradually by competing for those customers new to the market or dissatisfied with their current firm. This latter group is usually small. The size of the pool of newly arriving customers depends largely on the just described population dynamics of the local market. The local competitive market can change significantly when one of the owners of a successful competitor firm seeks to retire. The owner of this firm can convey to a new owner a number of "pre-sold" customers or clients that would otherwise not be available through normal competition. The questions is: when and why would an owner of an economically viable service sector firm be motivated to sell their equity? Usually the answer is simply "when they have to."

An owner of an economically viable and successful small service sector firm usually chooses to sell when they reach retirement age, become disabled, die (in which case the seller is the owner's estate), or hit burn out. The more prudent owners of such firms have anticipated these circumstances and developed a succession plan which has identified and groomed a successor acquirer for the

takeover. In some fields it is common practice to execute continuation agreements with other competitor firms to insure against loss of customers due to death or disability.

Under less dire circumstances, owners of smaller service sector firms will consider *merging* with or being acquired by competitor firms. In these circumstances the owners usually expect to retain equity ownership in the merged or acquiring firm. These owners are also likely to remain active in the management of the successor firm. In any event when a successful service sector owner is forced or chooses to leave the market a rare opportunity arises. Who is in a position to exploit this opportunity? In other words, who's buying?

Who's Buying and Why?

Relatively few individuals have the combination of motivation and capacity to own and manage a small service sector business. In order to acquire a controlling equity interest in closely held small service sector firm, any PA, in addition to cash, must have a combination of sufficient expertise and experience to manage and operate the business. These requirements follow directly from the fact that most acquisitions of controlling interests are financed by either the seller or a third party. Without demonstrable expertise and related experience, financing would be withheld and the equity exchanges would not be consummated.

For most service sector closely held firms, the PA's required minimum levels of expertise and experience are very specialized. For example, to acquire a controlling interest and successfully operate a dental practice, one must generally be trained as a dentist. Similar observations apply to a wide range of businesses whose principal product is expertise. Furthermore, state laws often require the equity owners of professional service firms to possess the appropriate state licenses, available only to those who are properly qualified.

In the context of small closely held service firms, even cash combined with skill and experience is not sufficient. In these smaller investments, the controlling investor has to be *very* motivated and willing to work *full time* at the business. It is important to emphasize that investors in closely held businesses do not necessarily

view the additional responsibilities of ownership as an onerous burden. Rather, for many PAs, the investment in a closely held firm represents an ***opportunity*** to better leverage these assets in a synergistic fashion. The desired returns are often a combination of economic and psychological rewards. The economic rewards may be higher DE, while the psychological benefits may include greater autonomy, prestige and challenge.

Taking on the challenges and responsibilities of owner management of a small service sector business is not for every individual who possess the experience and expertise needed. Most skilled and experienced individuals in a service sector prefer to remain employees rather than owners. This works out well as a rule because as we have noted the number of economically viable competitors that can survive in any given local market is usually quite limited.

For the purposes of appraising closely held service sector firms it is useful to distinguish between PAs on the basis of scale:

- Small Scale PAs
- Equivalent Scale PAs
- Larger Scale PAs

If an SC operates at a small enough scale then it may attract PAs who are now employees or competitors with smaller operating characteristics. Smaller PAs are often skilled and experienced employees looking to become owner employees. These potential PAs are usually motivated by the desire for greater compensation and autonomy. Smaller scale SCs can also attract equivalent or bigger sized buyers. These are competitor firms that operate at the same scale or larger than the SC. For smaller scale SCs PAs of equivalent size may be harder to find because these firms usually seek a merger rather than an acquisition. Bigger PAs may also not be interested in an outright buyout and insist on a long term employment commitment from the current owner.

The reason that equivalent and bigger PAs may be reluctant to engage in an outright buyout has to do with concerns over attrition. Absent a continuation of the current ownership, loss of customers may be simply too high. Of course attrition is

of concern to smaller PAs as well. However, smaller PAs, particularly if they are already employed by the SC, may already have familiarity with many of the SC's customers or clients and therefore attrition may be less of a problem.

Bigger SCs are not likely targets of acquisition from smaller PAs simply because the resources required to own and manage these firms are beyond their capacity. These larger SCs are more likely to be merger targets with PAs of similar size or acquisition targets by larger regional or national firms.

In current practice appraisers are admonished to look at value from the standpoint of a *hypothetical* versus an actual buyer. The hypothetical buyer usually entails passive investors who will not be actively involved in the day to day management of the SC. However, most small local service sector SCs are not a suitable investment target for passive investors. The lack of liquidity and the need for direct day to day owner management excludes passive investors from the market. Emphasis on hypothetical buyers often hamstrings and makes economically meaningless the whole appraisal exercise. Under current prevailing practices, there is more than one standard of value and each standard turns on the definition of this hypothetical buyer. In the real world, apart from the doctrinal fantasies of current appraisal theory, there is one reality that must never be overlooked: an SC has value only to the extent that some rational economic actor with suitable skills, experience and resources could plausibly be willing to buy that company. In the sectors we are concerned with these are synergistic and not passive investors.

Summary

Small service sector markets are localized and the total amount of potential customers and the total revenue they are willing and able to spend is fixed at any given time. Customary scales of operation dictate that in any given local market only a fixed number of competitors can maintain economic viability. The quality of the provided services factors more heavily than price and convenience in customers' decisions to patronize one competitor firm in a local market. Once a customer is satisfied with the quality of a firm's services it is hard to induce them to switch to another competitor absent unexpected significant increases in prices or decreases in

convenience. For these reasons most forms of advertising are not cost effective. Referrals from existing customers tend to be the dominant source of new customers and clients. In most local markets competitor firms seek to grow to a fixed equilibrium level in which new customers and clients replace those who leave. Only in areas of rapid population growth are there likely to be the opportunities to compete successfully for in a given year the number of new customers that might be made available if one of the competitor firms drops out of the market. Therefore, buying an existing firm to gain access to its customer base is likely to be a much more cost effective way to gain customers than direct marketing. Such buying opportunities tend to be relatively rare in any given local market. Finally, in most local markets there are very few PAs with the both the capacity and motivation to acquire the equity of these service firms.

Chapter Notes

1. http://www.brainyquote.com/quotes/quotes/b/braddsmit687119.html?src=t small business.
2. Leo Troy, *Almanac of Business and Industrial Financial Ratios,* Aspen Publishers, New York, NY, 35th Edition, 2004.

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