



Family Values

The art and science of valuing collection agencies

BY THOMAS EDENS

Valuating a family business may be the most important exercise an agency owner goes through. For most agency owners, the business represents the largest concentration of their family's net worth. It is the collective accumulation of many years of hard work and sacrifice. Determining the value of an agency requires the careful analysis of the company-specific attributes of each agency. There are many reasons agency owners may want to determine the value of their business assets.

Reasons for valuation

The most common reasons for valuing a minority or controlling interest in closely held companies are as follows:

Estate planning—The agency owner may desire to implement any number of estate planning techniques, such as establishing a gifting program or using the discount leverage of family limited partnerships. A valuation is a critical part of the documentation process of the overall estate plan. If the valuation is determined to be unrealistically low, the Internal Revenue Service (IRS) can assess penalties on the estate after death.

Penalties can be as much as 30 percent of the tax deficiency.

Buy/sell agreements—Some agencies were started as a venture between two or more partners. Business valuations are a safeguard necessity for the documentation of the buyout price to be used in the buy/sell agreement.

Business sale—When an owner is planning to sell an agency to an employee, relative or independent third party, the valuation of the business is the most critical step, providing the foundation upon which negotiations will focus. Most business owners think they know what their businesses are worth but are usually too close to their companies to accurately assess the true value.

Subchapter S election—A tax advisor may advise that a Subchapter S election of the Internal Revenue Code is appropriate. This election may be beneficial for current income considerations or tax strategy when you decide to sell your agency in the future. Most agency sale transactions take the form of an asset sale, and the Sub S planning is a way to minimize the future tax cost of selling your business. Tax savings could easily

amount to several hundred thousand dollars on a typical asset sale arrangement. A valuation is often required to determine the amount of built-in gains as of the effective date of the Sub S election.

Conflict resolution—Frequently, a business is the center of a valuation dispute, such as divorce proceedings or minority interest disagreements. A professional valuation is the logical answer for resolving these conflicts.

The valuation of small and mid-sized businesses is often more difficult than larger enterprises because of the use of public company comparables frequently not being relevant. Large companies can more easily identify with and compare to similar companies that are traded on one of the exchanges. The smaller companies require more judgment and experience on the part of the person performing the valuation.

How to value agencies

The valuation of any business enterprise is not an exact science. Many economic, industry-specific and company-specific factors determine the final valuation of an agency. No one rule of thumb can be used

for all agencies. Too many subjective factors interrelate to arrive at the fair market value. However, guidelines have been derived from market conditions and transactions.

Typically, the objective of any agency appraisal is determining the fair market value—the price at which the agency would change hands between a willing buyer and seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell. Also, both parties would have reasonable knowledge of relevant facts.

Business valuations are similar to real estate appraisals in that three approaches— income, market and asset—are commonly used in each.

In applying the income approach, the appraiser attempts to compute a value based on the earnings capability of the business. The calculations typically compute one or more of the historic earnings stream, future earnings stream or the dividend payout capacity. Typically, the most relevant approaches to valuing debt collection agencies are the income and market approaches.

The market approach uses data gathered from outside sources. The appraiser attempts to identify other companies or assets that have sold or are being sold in the open market. Adjustments are then made to make the alternatives comparable to the subject company.

The asset approach derives most of its validity by analyzing the net assets of the company being appraised. The variations of this approach might include calculating the replacement cost of the business components or the liquidation value of the enterprise's net assets. The asset approach is typically less meaningful because agencies' valuations generally exceed the sum of their corporate assets less liabilities. However, the agency's assets are an important variable in determining the final valuation using the income or market approach.

Income approach

The most useful approach in valuing agencies, because of their service nature, is using their income or cashflow stream. There are several income streams that could be used, such as net income before tax, net income after tax, net cashflow and gross cashflow. The most common income stream used to value collection agencies is the amount computed using the pre-tax net cashflow stream. This net cashflow stream is

generally defined as net income before tax, interest expense, depreciation, after giving consideration to excess owner compensation. After determining the net cashflow, a capitalization rate, or cashflow multiple, must be applied to the benefit stream.

Most family-run businesses are operated with a sub-goal of reducing corporate income taxes as much as possible. This motive leads to most income statements having a negligible reported income. The exercise of recasting the income is one of primarily determining the net owner's benefits that are buried in the different income statement accounts.

The usual add-backs to income are personal travel, non-essential family members' salaries and various other personal expenses paid by the company. An adjustment is usually required for excess owner compensation. This adjustment will add to the income the amount of the owner's salary above what an executive would earn to manage the agency. There must be a separation of market salaries and return on owner investment. The market salary portion of the compensation should remain as a deduction from cashflow while the excess should be added back as an owner benefit.

Table A should help illustrate the net cashflow calculation most often used by agency buyers.

TABLE A

Recast pre-tax cashflow

Annual fees	\$1,500,000
Net income before tax	\$93,000
Recast adjustments:	
<i>Add:</i> Depreciation	\$37,000
Interest expense	\$21,000
Owner perks	\$97,000
Owner salary & bonus	\$171,000
<i>Less:</i> Replacement manager	-\$60,000
Pre-tax net cashflow	\$359,000

The calculation of the net cashflow is a fairly straightforward calculation. That is where the science ends and the art begins. The resultant cashflow stream is then capitalized by an appropriate pre-tax capitalization rate. The capitalization rate most commonly used ranges from 33 percent to 20

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percent. A cap rate of 16 percent usually reserved for the larger, more desirable acquisition candidates, and a 33 percent rate could be applicable for the smaller agencies with no competitive advantage. This cap rate can be translated into a multiple of net cashflow. For example, a 25 percent cap rate is equivalent to a four multiple, and a 20 percent cap rate would equate a five multiple.

One of the most common questions regarding valuation is what determines the multiple. Unfortunately, there is no simple answer.

Many factors determine what cap rate or multiple is appropriate for a specific agency. The more common factors analyzed to determine the multiple are as follows:

Predictability of cashflow. The greater the predictability of the earnings stream, the larger the multiple.

Concentration of clients. The greater the percentage of business applicable to one client, the greater the degree of risk of the future cashflow stream and correspondingly, the lower the multiple.

Management in place. The greater the quality of management depth, the higher the value. This is especially true for sales management and collection management personnel.

Agency size. The larger the agency, the greater the multiple.

Equipment. All things remaining equal, the agency with the more technologically advanced equipment will be worth more than an agency with outdated hardware, software, telephone and dialing equipment.

Quality of client base. Agencies with many long-standing clients will earn a greater valuation than agencies with high turnover clients.

Other factors. Geographic location, years in business, quality of inventory of accounts in-house, level of perceived owner identity ver-

sus an easily transferable client base, the state of the economy and specific market niches all play a part in the subjective equation of value. Since the actual level of assets of most agencies is relatively low compared to the total enterprise value, most of the value amount represents goodwill of the agency.

Other approaches

The market and asset approaches are not used as frequently as the income approach for valuing agencies. The net asset method is an asset approach that assumes the agency will enter into this hypothetical sale of all its assets and extinguish all of its liabilities. Under this method, the common equity is restated based on the market value of the assets of the company less the market value of the liabilities. This method is especially less applicable for medium and large agencies because of the service nature of the industry versus asset-intensive industries.

The market approach attempts to identify agencies with similar economic and operational characteristics as the subject agency that is being valued. For most business owners and appraisers, it is difficult to gain access to data on agencies that have sold because of the confidential nature of most sale transactions. The number of business intermediary firms that maintain their own proprietary sales transaction data base is limited.

Summary

The valuation of a collection agency is a subjective exercise that cannot be accomplished with simplistic rules applied by inexperienced business owners or business appraisal practitioners. As IRS requirements expand and merger and acquisition activity intensifies, the valuation of agencies is becoming a more frequent and more important activity for many business owners. CM

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