Email: Susannah@Sabnekar.com

Overcoming a Business Selling and the Previous Owner Opening Next Door

By Susannah Sabnekar, CPA/ABV, DABFA

(As Published in the December 2004 Edition of the BV Q&A Update)

The Question as presented:

How do you overcome the very simple example that if the business owner was to leave the business, and open up next door and compete, that the Company would suffer enough revenue loss that it would not generate profit and thus no one would ever pay anything more than book value? It seems that this scenario would be likely to exist in a majority of small business valuations and thus all goodwill, if any, is personal.

The Answer

The focus of this answer is from the family law perspective given that in most other valuation scenario's we seek to value the owner's entire equity interest resulting in little, if any, need to determine the allocation between the tangible and intangible amounts.

While there are situations where all of the goodwill is personal, many businesses are able to generate revenue from continued patronage without the owner.

Our real challenge is to assess the value ascribed to personal and business goodwill through a careful analysis of the components and operations of the business. The various factors to consider are set forth below. An excellent proxy for the value of personal goodwill is either the value of non-competes that have been observed in the market place or the value of employment contracts in place.

Background

Family law courts in multiple jurisdictions are requiring that business appraisers separate personal and business goodwill in valuations for marital dissolution purposes. This is not mandatory in all jurisdictions. However, various appellate courts hold that personal goodwill is not subject to equitable distribution.

Professional or personal goodwill is defined as the intangible value associated primarily with the individual owner or practitioner.

Practice, entity, or business goodwill is the intangible value that is associated with the practice as an institutional entity.

While there *are* businesses or professional practices in which all of the goodwill is personal, a thorough analysis of the factors that separate personal and business goodwill generally suggests that some portion of the goodwill is appropriately defined as business goodwill.

Specific Factors to Consider

We are required to assess and document the type of goodwill by looking at the following broad categories:

Type of Service:	Is it personal labor (representative of personal goodwill) or is it manufacturing (representative of business goodwill)?
Customers:	Are they referred to the business (generally business goodwill) or to the owner (generally personal goodwill)?
The Company:	Is there a trained work force (representative of business goodwill)? Is this a startup enterprise (generally representative of business goodwill) or a mature company (generally some component of goodwill is personal)? Is the business name itself marketable (entity goodwill) or is it named as John Doe Practice (professional goodwill)?
Owner:	Reputation, age, work habits, knowledge, and judgment. What succession plan, if any, is in place?
Restrictions:	What is the total size of the market? When many competitors exist, there is generally significant professional goodwill; however, when few competitors exist goodwill is likely to be best classified as entity goodwill. What covenants and financial guarantees exist? Generally covenants and financial guarantees suggest that professional goodwill exists.

Specific approaches that may be used to attempt to establish the value of personal goodwill are as follows:

Top-Down Approach: Under this approach the business is valued at its enterprise value using the methods typically employed to determine value. One would then proceed to identify the discrete components of personal goodwill (the items discussed above) and reduce the initial valuation conclusions by the amount of the personal goodwill identified.

Bottom-Up Approach: Using this methodology, the valuation process would start with the adjusted book value. The tangible assets along with the identifiable intangible assets (such as patents, copyrights, and trademarks) are valued at current fair market value and added to the adjusted book value. To this amount, one would add the components of business goodwill, such as: business location, workforce in-place, established internet business, etc.

With and Without Approach: Under this approach, two separate valuations must be conducted. For the first, the business is valued under the assumption that the in-spouse continues to own the enterprise. For the second valuation, the business is valued assuming that the in-spouse no longer operates the business. We would normally assume that the cash flow generated would decrease in the second valuation either from loss of business revenue (if professional goodwill is identified) or from additional payments required to be made to the departed owner or expenses that might be higher given the need to execute an employment agreement with the owner.

When personal goodwill must be excluded, an excellent proxy for the amount of goodwill that is personal is the value of non-competes executed in the market place. The market sales transaction method that examines transactions as reported by Bizcomps, Done Deals, Pratt's Stats, and IBA frequently identifies the value assigned to non-compete agreements. Typically, this value is included within the sales price.

For example, let us assume that through using the capitalization of earnings method the initial valuation conclusion is $300,000. However, upon completion of the direct sales transaction method the value conclusions, after eliminating the effects of the non-compete, are $150,000. It would be quite defensible to take the position that the $150,000 difference (the value of the non-compete) is in fact personal goodwill.

Similarly, the value of personal goodwill may be established by the value of the employment agreement that is executed in these "real sale" transactions.

Summary

Separating personal and business goodwill will most likely continue to be challenging. While in theory, it seems that this process should be straight forward, it is extremely difficult in practice, given the subjective nature of the various components. Obtaining reliable information concerning the value of non-competes and employment agreements executed in the open market may assist valuation experts in this area.

Work Cited

Please call for references.