I. BUSINESS VALUATION APPROACHES AND METHODS

There are three fundamental ways to measure the value of a business or professional practice:

- Asset approach.
- Market approach.
- Income approach.

Under each approach, a number of methods are available which can be used to determine the value of a business enterprise. Each business valuation method uses a specific procedure to calculate the business value.

No one business valuation approach or method is definitive. Hence, it is common practice to use a number of business valuation methods under each approach. The business value then is determined by reconciling the results obtained from the selected methods. Typically, a weight is assigned to the result of each business valuation method. Finally, the sum of the weighted results is used to determine the value of the subject business.

This process of concluding the business value is referred to as the business value synthesis.

Asset Approach

The asset approach to business valuation considers the underlying business assets in order to estimate the value of the overall business enterprise. This approach relies upon the economic principle of substitution and seeks to estimate the costs of recreating a business of equal economic utility, i.e. a business that can produce the same returns for its owners as the subject business.

The business valuation methods under the Asset Approach include:

- Asset accumulation method.
- Capitalized excess earnings method.

Market Approach

Under the Market Approach to business valuation, one consults the market place for indications of business value. Most commonly, sales of similar businesses are studied to collect comparative evidence that can be used to estimate the value of the subject business. This approach uses the economic principle of competition which seeks to estimate the value of a business in comparison to similar businesses whose value has been recently established by the market.

The business valuation methods under the Market Approach are:

- Comparative private company transaction method.
- Comparative publicly traded company transaction method.

Income Approach

The Income Approach to business valuation uses the economic principle of expectation to determine the value of a business. To do so, one estimates the future returns the business owners can expect to receive from the subject business. These returns are then matched against the risk associated with receiving them fully and on time.

The returns are estimated as either a single value or a stream of income expected to be received by the business owners in the future. The risk is then quantified by means of the so-called capitalization or discount rates.

The methods which rely upon a single measure of business earnings are referred to as direct capitalization methods. Those methods that utilize a stream of income are known as the discounting methods. The discounting methods account for the time value of money directly and determine the value of the business enterprise as the present value of the projected income stream.

The methods under the Income Approach include:

- Discounted cash flow method.
- Multiple of discretionary earnings method.
- Capitalization of earnings method.

II. ASSET-BASED BUSINESS VALUATION RESULTS

To estimate the value of the subject business under the Asset Approach, this report uses the **Capitalized Excess Earnings** method. The method works to determine the business value as the sum of the following:

1. The fair market value of the business net tangible assets.
2. Business goodwill.

For the purposes of this report, the net tangible assets are determined as the difference between the total assets of the business and its current liabilities.

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Business goodwill is calculated by capitalizing the value of business "excess earnings". Excess earnings are the difference between the business Net Cash Flow and a fair return on the net tangible assets. We use the discount rate as the proxy for this fair rate of return. The equity discount rate is calculated by the **Build-Up Procedure** as follows:

$$d = R_f + P_e + P_s + P_i + P_c$$

Where d is the discount rate, R_f is the risk-free rate of return, such as the US Treasury bond yield, P_e is the risk premium for public company stock investment, P_s is the premium for small company size, P_i is the industry-specific premium and P_c is the risk premium specific to the subject business.

The table below summarizes the discount rate calculation:

Discount Rate Element	Risk Value	Notes
Risk-free rate of return	3.00%	Current US Treasury bond yield is used.
Premium for equity investment	6.10%	Risk premium for investing in public company stock.
Premium for small company size	9.85%	Risk premium for investing in a small company.
Industry-specific risk premium	1.02%	SIC 8742, Management Consulting Services.

Company-specific risk premium	2.50%	Company-specific risk premium.
Equity Discount Rate	22.47%	Sum of the risk-free return plus the risk premia above.
Net Cash Flow Growth Rate	3.52%	Long-term growth rate in subject business Net Cash Flow.
Capitalization Rate	18.95%	Difference between the Equity Discount Rate and NCF Growth Rate above.

Table 5. Equity Discount Rate Build Up

The subject business has no long-term debt; hence the equity discount rate adequately represents the firm's cost of capital.

To determine the capitalization rate for business goodwill calculation, we use the discount rate above and the average Net Cash Flow growth rate from the financial forecasts table, which is calculated as 3.52%. The difference between the two gives us the capitalization rate of 18.95%. This is used to calculate the value of business goodwill as the capitalized value of the business excess earnings.

With the values of the assets and current liabilities from the adjusted balance sheet above and the business earnings basis equal to the average of historic Net Cash Flows of $244,690; the business value indicated by the Capitalized Excess Earnings method is:

- Value of Net Tangible Assets: $311,946.
- Value of Business Goodwill: $953,781.

Business Value: **$1,265,727**

III. MARKET-BASED BUSINESS VALUATION RESULTS

The market-based business valuation relies upon the comparison of the subject business to similar businesses that have actually sold.

There are several sources of market data commonly used:

- Publicly traded company sales.
- Private company sales.
- Previous sales of the subject business.

In this report, we use the private company sales data. The companies selected for comparison are closely held firms which resemble the subject business in terms of their financial and operational characteristics.

We utilize the **Comparative Transaction Method** to estimate the value of the subject business. Under this method, one determines the so-called valuation multiples which relate some measure of business financial performance to its potential selling price. Typical valuation multiples are:

- Price divided by the business gross revenues or net sales.
- Price divided by the seller's discretionary cash flow.
- Price divided by the business net cash flow.
- Price divided by EBIT, EBT, or EBITDA.
- Price divided by the fair market value of the business asset base.

Each valuation multiple is a ratio statistically derived from the selling prices and financials of the sold private companies in the same industry as the subject business.

We calculate each valuation multiple as a weighted average of the lowest (minimum), median, average and highest (maximum) values as follows: a weight of 50% is assigned to the median valuation multiple, 25% to the average, and 12.5% each to the minimum and maximum values.

Valuation Multiple	Minimum	Median	Average	Maximum	Weighted Valuation Multiple
Price ÷ Gross Revenue	0.1010	1.1299	1.2800	1.7900	1.1213
Price ÷ Net Sales	0.1010	1.1300	1.2450	1.8100	1.1151
Price ÷ Seller's Discretionary Cash Flow	0.7600	3.0150	3.3850	3.5200	2.8888
Price ÷ Net Cash Flow	0.8000	3.9050	3.9700	4.5500	3.6138
Price ÷ EBITDA	0.8400	13.2500	14.0010	17.1250	12.3709
Price ÷ Total Assets	0.7500	5.5000	7.0555	18.4553	6.9145

Table 6. Business Valuation Multiples

In the table below, the following basis values are calculated as historic averages taken from the reconstructed income statement:

- Gross revenue
- Net sales
- Seller's discretionary cash flow
- Net cash flow EBITDA

The total asset basis value is taken from the reconstructed balance sheet table above.

The basis values shown in Table 7 below are calculated as the averages of the reconstructed financial values for the two most recent years.

Type of Value Estimate	Basis	Weighted Multiple	Estimated Value
Price based on Gross Revenue	$960,553	1.1213	$1,077,092
Price based on Net Sales	$958,951	1.1151	$1,069,350
Price based on Seller's Discretionary Cash Flow	$318,176	2.8888	$919,131
Price based on Net Cash Flow	$251,898	3.6138	$910,297
Price based on EBITDA	$71,886	12.3709	$889,293
Price based on Total Assets	$389,296	6.9145	$2,691,802
Average:			**$1,259,494**

Table 7. Business Value Estimation using Multiples

To arrive at an estimate of the business selling price, we use each weighted valuation multiple and multiply it by the corresponding numerical value of the subject business' earnings or assets basis.

We next determine the business value as the average of these selling price estimates, as shown in this table.

Business Value: $1,259,494

Rules of Thumb

Market-driven Rules of Thumb afford another way to estimate the value of the subject business based upon the empirical evidence of business selling prices in the same industry.

When offered for sale, comparable businesses are frequently priced based upon their annual gross revenues. We use the Rules of Thumb for General Business Consulting (SIC 8741) and Management Consulting (SIC 8742) industries to develop our business value estimates.

The annual gross revenues basis value of $960,533 from Table 7 is utilized to generate the business value results below:

Industry	Low	Median	Average	High
General Business Consulting, SIC 8741	$200,000	$900,000	$1,200,000	$1,500,000
Management Consulting, SIC 8742	$225,000	$955,000	$1,105,500	$1,375,300
Average:	**$212,500**	**$927,500**	**$1,152,750**	**$1,437,650**

Table 8. Business value estimation using Rules of Thumb

We determine the business value estimate as a weighted average of the average values in Table 8 as follows: a weight of 50% is assigned to the median value, 25% to the average value; with 12.5% each assigned to the low and high average value estimates.

Business Value: $958,206

IV. INCOME-BASED BUSINESS VALUATION RESULTS

Discounted Cash Flow method

This income-based business valuation method provides highly accurate estimate of business value based on the business earning potential. Under this method, we determine the business value by discounting the future business earnings using the so-called discount rate which captures the business risk.

The use of this method requires the following three inputs:

1. Business net cash flow forecast over a pre-determined future period
2. Discount rate
3. Long-term residual business value

Our Income Statement forecast provides the net cash flow numbers five years into the future. Since the subject business is debt-free, we use the equity discount rate calculated earlier. Finally, the residual business value which represents that portion of business value past the net cash flow projection period is calculated as follows:

$$R = \frac{CF_5 \times (1+g)}{(d-g)}$$

In this relationship, CF_5 is the net cash flow estimated in year 5 of our forecast, g is the long-term growth rate in the net cash flow, and d is the discount rate. We calculate g as the average growth rate given our five-year cash flow projection. The residual business value at the end of year 5 is thus $1,700,557.

Under these assumptions, we arrive at the following estimate of business value:

Business Value: $1,430,035

Multiple of Discretionary Earnings method

The Multiple of Discretionary Earnings method is a variant of the direct capitalization methods under the Income Approach. Essentially, this method establishes the business value as a multiple of its earnings adjusted for the net working capital, nonoperating assets, if any; and long-term liabilities.

Earnings Basis Calculation

To determine the business value using this method, we use the Seller's Discretionary Cash Flow (SDCF) as the basic measure of the business earning power.

We estimate SDCF as a weighted average of historic values obtained during the company's income statement reconstruction.

This weighted average SDCF calculation is summarized below:

Year	Weight	SDCF	
2012	1	$282,654	
2013	2	$316,173	
2014	3	$313,707	
2015	4	$322,645	
Weighted average SDCF			**$314,670**

Table 9. Seller's Discretionary Cash Flow calculation

Adjustments to determine the business value

To estimate the equity value of the business, we factor in the values of the net working capital; $24,834; and non-operating assets; $155,500; which we determined earlier in the process of reconstructing the business historic income statements and balance sheet. These values are added to the product of SDCF; $314,670; and the earnings multiplier as determined below.

Consistent with the assumption of an asset business sale, we do not adjust our business valuation result by the value of the business long-term liabilities. These liabilities are assumed to be paid off by the seller prior to closing.

Business valuation factor values selection

This SDCF measure is then capitalized by an appropriate multiplier. The multiplier is derived by analyzing the subject business performance across 14 financial and operational areas. Each area is associated with a valuation factor. We assign a numerical value to each factor as follows:

Valuation Factor	Range	Assigned Value
Business earnings track record	0.1 – 4.0	2.5
Industry growth	0.1 – 4.0	2.5
Business growth	0.1 – 4.0	2.5

Access to acquisition financing	0.1 – 4.0	2.5
Competition	0.1 – 4.0	3
Business location	0.1 – 4.0	3
Customer concentration	0.1 – 4.0	3
Product / service concentration	0.1 – 4.0	3
Market concentration	0.1 – 4.0	3
Nature of business	0.1 – 4.0	3
Desirability	0.1 – 4.0	3
Ease of operation	0.1 – 4.0	2.5
Quality of employees	0.1 – 4.0	3
Strength of management team	0.1 – 4.0	3

Table 10. Business Valuation Factors selection

Factor values in the 0.1 – 1.0 range reflect sub-par business performance, when compared to the industry norms. Values in the 1.5 – 2.5 range indicate average business performance in the selected area. Factor values in the 3.0 – 4.0 range represent above average to exceptional performance. They result in the capitalized business values at the upper limit that can be supported by the requirements of reasonable return on business investment and compensation for the working business ownership.

With all the necessary inputs thus determined, the application of the Multiple of Discretionary Earnings method gives the earnings multiplier of 2.748 and produces the following business value result:

Business Value: $1,045,047

V. CONCLUSION OF BUSINESS VALUE

We relied upon five methods under the Asset, Market and Income Approaches to business valuation: Capitalized Excess Earnings method, Comparative Transaction method, Industry Rules of Thumb, Discounted Cash Flow and Multiple of Discretionary Earnings methods.

We use the results obtained from these business valuation methods to provide an estimate of the subject business value. In our opinion, each of the business valuation methods utilized in this Report is equally relevant. Hence, we assign an equal weight to each result and calculate our estimate of the business value as the sum of these weighted values:

Business Valuation Method	Approach	Value	Weight	Weighted Value
Capitalized Excess Earnings	Asset	$1,265,727	20%	$253,145
Comparative Transactions	Market	$1,259,494	20%	$251,899
Industry Rules of Thumb	Market	$958,206	20%	$191,641
Discounted Cash Flow	Income	$1,430,035	20%	$286,007
Multiple of Discretionary Earnings	Income	$1,045,047	20%	$209,009
Indicated Business Value				**$1,191,702**

Table 11. Conclusion of Business Value

Indicated Business Value: $1,191,702

VI. BUSINESS VALUE AND SELLING PRICE CONSIDERATIONS

A number of consideration affect the price a business sells for. We consider the major factors in what follows.

Business sale financing

Small business purchases are generally financed by a blend of debt and equity capital. The most common forms of equity financing are the buyer down payment. The common sources of debt capital include some form of seller financing and, possibly, 3rd party debt financing such as the government-backed or commercial bank loan.

This is quite different from the merger and acquisition deals involving publicly traded companies. These companies have direct access to the public capital markets which makes raising the required acquisition capital much easier than for closely held firms.

Access to adequate debt and equity capital required to successfully close the deal is a major prerequisite to a successful small business sale.

Business sale terms

The terms of a small business purchase can make a substantial difference to the actual selling price. The amount of equity capital required from the buyer to close the deal has a material effect on the type of return the buyer can expect from the investment.

On the other hand, debt financing terms, whether offered by the seller or secured from a bank, affect the levels of cash flow required from the small business to make its acquisition financially worthwhile.

Availability of debt financing on reasonable terms can have a major impact on the price the business ultimately sells for.

As is customary, our business valuation conclusions are done at "face value", which is not adjusted for the terms of a business sale.

Business buyer and seller motivations

The price a business sells for depends on the motivations of the seller and the buyer.

There are a number of reasons a business may be offered for sale, including:

- Owner death or poor health
- Retirement
- Search for new business opportunities
- Burnout
- Partner disputes
- Unsatisfactory business financial performance or lack of investment capital.

Ideally, the seller can command the highest selling price if the business sale is timed when the business financial performance is at its peak and market conditions for the business sale are best. In reality, circumstances may compel the seller to put the business on the market when the conditions are less than optimal, thus affecting the actual selling price.

A buyer may be motivated by a number of factors which may affect what he or she is prepared to pay for the business:

- Replacing a job income
- Looking for a business which complements the buyer's existing businesses
- The capital available for a business purchase

- How well the buyer's skill set matches the key business requirements
- Buyer's long-term goals and lifestyle considerations.

In particular, the buyer's investment goals, compensation requirements and available acquisition capital may make a material difference to the offer price and terms.

VII. BUSINESS PRICE JUSTIFICATION

In this section we review a potential business selling price and reasonableness of terms based on a hypothetical business sale scenario. Our objective is to calculate the cash flow required from the business to reasonably support its acquisition.

This review is based on the assumption of an arms-length transaction and does not account for synergistic benefits that may be realized by a specific business buyer.

We assume the typical asset sale acquisition scenario, common to most of small business purchases. Under this scenario, the buyer acquires the underlying business assets without the assumption of its liabilities.

In addition to the purchase price, the buyer will need to inject adequate working capital to support normal business operations.

To conclude the business purchase, the buyer will also incur certain transaction costs. These costs typically include professional and brokerage fees, licenses and permits, financing charges and closing costs.

Given an acquisition deal structure, the business cash flow must cover the following requirements:

- Debt service, including adequate debt service coverage ratio.
- Reasonable return on the business buyer's down payment.
- Sufficient compensation for the owner-operator.
- Capital expenditures needed to operate the business.

Business sale scenario assumptions

Assumption	Value	Notes
Project Cost		
Business Purchase Price	$1,000,000	Contract business purchase price
Transaction Costs	$15,000	Buyer costs associated with purchase
Working Capital	$204,834	Buyer contributes to fund business short-term financial needs
Total Project Cost:	$1,219,834	Sum of all items above
Deal Structure Elements		
Buyer Down Payment, %	20%	Buyer equity investment, % of Total Project Cost
Seller's Note, %	30%	Seller financing offered
Seller's Note Term, years	7	Note term in years
Seller's Note Interest, %	7.25%	Fixed annual interest charged
Bank Loan, %	50%	3rd Party financing the balance of sale
Bank Loan Term, years	10	Loan term in years
Bank Loan Interest, %	7.5%	Fixed annual interest charged
Financial Requirements		
Return on Down Payment, %	20%	Annual return on the buyer's down payment
Owner's Compensation	$80,000	Total compensation for a single owner-operator
Capital Expenditures	$10,000	Annual long-term investment required to support business operations

Table 12. Business Sale assumptions

Available cash flow calculation

We next calculate the annual business cash flow in the first year following the business purchase that is required to support all the business purchase assumptions above. Note that the debt service coverage ratio of 1.25 is included in the cash flow calculation.

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Annual Debt Service: $153,694.

Annual Cash Flow Required: $330,911.
The available discretionary cash flow forecast for the first year following the date of this appraisal is $333,902. This appears adequate to support the transaction terms in Table 12 above.

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VIII. STATEMENT OF LIMITING CONDITIONS

This business appraisal relies upon the following contingent and limiting conditions:

1. We assume no responsibility for the legal matters including, but not limited to, legal or title concerns. Title to all subject business assets is assumed good and marketable.

2. The business interest and subject business assets have been appraised free and clear of any liens or encumbrances unless stated otherwise. No hidden or apparent conditions regarding the subject business assets or their ownership are assumed to exit.

3. All information provided by the client and others is thought to be accurate. However, we offer no assurance as to its accuracy.

4. Unless stated otherwise in this report, we have assumed compliance with the applicable federal, state and local laws and regulations.

5. Absent a statement to the contrary, we have assumed that no hazardous conditions or materials exist which could affect the subject business or its assets. However, we are not qualified to establish the absence of such conditions or materials, nor do we assume the responsibility for discovering the same.

6. Per agreement with the client, this is a restricted appraisal report as defined under the USPAP Standard 10. Not all pertinent information has been considered nor was a comprehensive valuation undertaken. This may affect the value conclusions presented in this report.

7. The report may not fully disclose all the information sources, discussions and business valuation methodologies used to reach the conclusion of value. Supporting information concerning this report is on file with the business appraiser.

8. The valuation analysis and conclusion of value presented in the report are for the purpose of this engagement only and are not to be used for any other reason, any other context or by any other person except the client to whom the report is addressed.

9. The opinion of value expressed in this report does not obligate us to render a comprehensive business appraisal report, to give testimony, or attend court proceedings with regard to the subject business assets, properties or business interests, unless such arrangements have been made previously.

10. Possession of this report does not imply a permission to publish the same or any part thereof. No part of this report is to be communicated to the public by means of advertising, news releases, sales and promotions or any other media without a prior written consent and approval by us.

11. This report is valid only for the date specified herein.

IX. APPRAISER CREDENTIALS AND CERTIFICATION

Jane Analyst, ASA, CBA, MBA

Master of Business Administration, Finance, Harward Business School. University of California, Berkeley, Bachelor of Science, Finance.

American Society of Appraisers, Accredited Senior Appraiser, Business Valuation.

Institute of Business Appraisers, Certified Business Appraiser.

Position and Experience

Senior Valuation Analyst, Partner, Certified Business Appraisals, LLC.

Professional Affiliations

American Society of Appraisers

Institute of Business Appraisers

I certify that, to the best of my knowledge and belief, the statements of fact contained in this report are true and correct; the reported analyses, opinions, and conclusions are limited only by the reported assumptions and limiting conditions and are my personal, impartial, and unbiased professional analyses, opinions, and conclusions. I have no present or prospective interest in the property that is the subject of this report, and I have no personal interest with respect to the parties involved. I have performed no services, as an appraiser or in any other capacity, regarding the property that is the subject of this report within the three-year period immediately preceding acceptance of this assignment. I have no bias with respect to the property that is the subject of this report or to the parties involved with this assignment. My engagement in this assignment was not contingent upon developing or reporting predetermined results. My compensation for completing this assignment is not contingent upon the development or reporting of a predetermined value or direction in value that favors the cause of the client, the amount of the value opinion, the attainment of a stipulated result, or the occurrence of a subsequent event directly related to the intended use of this appraisal. My analyses, opinions, and conclusions were developed, and this report has been prepared, in conformity with the Uniform Standards of Professional Appraisal Practice. No one provided significant business and/or intangible asset appraisal assistance to the person signing this certification.

Signed, Jane Analyst

X. LIST OF ABBREVIATIONS

Asset Sale – a type of small business sale transaction in which all underlying business assets transfer from the seller to the buyer.

The buyer assumes no business liabilities.

Average – the arithmetic mean value, calculated by adding all the values in a set and dividing the sum by their number. For the business selling price, the average is the sum of all the deal prices divided by the number of the recorded business sales.

Days on Market – the time in days from the date the business is listed for sale until the transaction closes.

Earnout – a portion of the business purchase price that is made contingent upon the business achieving some future measure of economic performance. For example, the earnout can be structured as a percentage of sales in excess of some base number, paid over some future period of time and limited to a maximum.

EBITDA – earnings before interest, tax, depreciation and amortization.

EBIT – earnings before interest and tax expense.

EBT – earnings before tax expense.

FF&E – the portion of business operating asset base comprising its furniture, fixtures and equipment.

Max – the maximum value in a set of values. For the business selling price, this is typically the highest recorded selling price value.

Median – the mid-range value with half of the values in the set falling below it and another half being above it. For the business selling price, the median price means that 50% of the business sales were done at prices below the median, and the remaining 50% of the sales had prices above the median.

Min – the minimum value in a set of values. For the business selling price, this is typically the lowest recorded selling price value.

N/A – not available.
Pricing Multiple – a statistically derived ratio of the business selling price to a measure of the business economic performance such as the business revenue, profit or cash flow.

Purchase Price – the total monetary consideration paid for the business equity. Includes intangibles such as non-compete agreements, excludes real estate, long-term liabilities assumed, and earnouts.

Purchase Price ÷ Net Sales – a pricing multiple which equals the purchase price divided by the business net sales.

Purchase Price ÷ EBT – a pricing multiple which equals the purchase price divided by the business earnings before tax.

Purchase Price ÷ Net Income – a pricing multiple which equals the purchase price divided by the business net income.

SDCF – seller's discretionary cash flow is the business net pre-tax income before a single owner's total compensation, plus amortization, depreciation, interest expense and adjusted for any extraordinary, non-recurring or non-business related income or expenses.

Selling Price – the monetary consideration paid for 100% of business ownership interest in an asset sale transaction. The Selling Price includes all business assets except cash, accounts receivable and inventory. Accounts payable are also excluded. The Selling Price does not include any long-term liabilities assumed by the buyer.

Selling Price ÷ Gross Revenue – a pricing multiple which equals the business selling price divided by the gross annual sales.

Selling Price ÷ SDCF – a pricing multiple which equals the business selling price divided by the SDCF.

SIC – Standard Industrial Classification, a US classification system grouping like businesses under the same numerical code.

Total Invested Capital – the purchase price plus all long-term business liabilities that are assumed by the buyer.

Total Invested Capital ÷ EBIT – a pricing multiple which equals the total invested capital divided by the business earnings before interest and taxes.

Total Invested Capital ÷ Gross Profit – a pricing multiple which equals the total invested capital divided by the firm's gross profit.

Total Invested Capital ÷ Net Sales – a pricing multiple which equals the total invested capital divided by the business net sales.

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