Valuations for SBA 7(a) Loans

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Unfortunately there are no real definitive guidelines for business appraisals published by the SBA that appraisers can use to understand the psychology involved in the SBA's scrutiny of the appraised values for businesses for 7(a) loan purposes. However, after 35 years of appraisals with the SBA, with the exception of the current limit on goodwill financing, the SBA's psychology regarding business appraisal, I feel is very sound and logical.

SBA on Earnings

Again, over the years, I have learned that logic dictates the way the SBA will consider the earnings used in the appraisal. The following are some expenses and SBA's psychology on their being added back to earnings:

Management Compensation

The SBA wants the deduction for management compensation to represent the amount needed to support the buyer's present lifestyle. In other words, if $50,000 is a normal compensation for the owner's duties but the new buyer must have $90,000 to sustain his or her present lifestyle, $90,000 is what the SBA will use.

Contributions and Subscriptions

Every business owner needs to know what is going on in their industry and subscriptions are necessary to keep up with trends and regulations, and yes, a subscription to Powerboat Magazine in the reception area of my Dentist is not discretionary. Also, contributions are usually a form of advertisement in the community and are necessary to a good company image.

Floor Planning Interest

This cannot be added back on many types of companies such as automobile dealerships as it is really considered a normal expense in the cost of the inventory. It is not a note that principle on the loan is being reduced.

Bad Debts that are normal each year

Look at the prior years to determine if the company's bad debts are inherent in the nature of the business.

Medical and Auto Insurance

This is another area to use your logic in. Is this a normal part of a compensation package for this type of company?

Repairs, Maintenance, and Gas for the owner

Again, is this a normal part of a compensation package for this type of company. If the use of the owner's vehicle is required to check on job sites or make sales calls it should not be added back.

Unreasonable amounts for travel and entertainment

Common sense again dictates the decision. A trip to Europe for a Convenience store owner would be reasonable to add back but not the owner of a European Wholesale distributorship.

One-time or non-recurring expenses

Again, use common sense. All companies have regular maintenance and things need to be replaced or remodeled to keep a good public appearance. On the other hand, building costs for more space or legal expenses for the owners divorce would be considered a non-recurring expense

Minor payments for owners home repairs, personal phones and home utilities

These can be considered if the owner has proof they were paid by the business.

Deducting a "Fair Market Rent" when the real estate is owned

Real Estate is usually financed in a separate loan so to establish the value of the business a fair market rent needs to be deducted from earnings. If the company pays rent, then the appraiser needs to make sure it represents fair market.

Other discretionary expenses by the loan officer

Many times the bank's loan officer will have certain expenses that the bank will not allow. There are other expenses that the bank will ask you to eliminate as the new owner will not incur them. One of the expenses is a deduction for management compensation as the new owner already has sufficient management in place to handle the new location and the purchaser's existing business supports him very nicely.

Other Financial Analysis Acceptable

In many cases valuing the company strictly under the definition of Fair Market Value will not yield a value representing the psychology of the deal. For instance, take for example Joe's Transmission shop that has been losing money for the last couple of years and the future looks bleak. Usually the value is going to only represent the assets of the business and the appraised value is $50,000. But let's say that Ernie, who owns 3 AAMCO Transmission franchises, is the buyer and has struck a deal with Joe to buy his shop for $100,000 . Now what Joe did in the past and the outlook for the future has totally changed.

When Ernie changes the name to Ernie's AAMCO #4, his top notch assistant manager for store #3 will be the new manager of store #4 and will have a salary increase of $10,000 but the existing manager of store #4 is no longer needed and eliminates his salary of $32,000. Bookkeeping costs of $6,000 a year are eliminated and advertising for the new store can be added to Ernie's existing advertising which eliminates the $15,000 on Joe's financial statements.

Ernie does provide health insurance to his employees so this will add $17,000 in expenses for store #4. The most significant change is that Joe's cost of goods were running 59% but Ernie's costs from the national supplier are only 30%. This will save the company 29% and equates to a $77,000 reduction in cost of goods.

After adjusting the financials for Joe's shop under Ernie's ownership it is very profitable and the appraised value is now $175,000.

This type of appraisal based on earnings after the purchase is perfectly acceptable to the SBA and again is logical. Also it was a true scenario (names changed) for an appraisal we did last month that SBA approved.

SBA on Assets

Naturally Real Estate is the preferred asset but good fast selling equipment makes them happy also.

Keep in mind that, if the loan package does not include a machinery and equipment appraisal by a qualified appraiser, you must use book value in the appraisal. If the business being sold has intangibles such as licenses, patents customer lists, non-compete agreements, and franchise rights on its balance sheet, the book value can be used for these assets. Intangibles that do not have an existing book value may not be used as an asset.

SBA on Goodwill

The definition of Goodwill by the SBA is;

"Goodwill" is created when an existing business is acquired and the acquiring entity pays more for the business than the book value of the business's assets. Simply put, "goodwill" is the premium the seller is requiring as part of the purchase price (and the buyer is willing to pay) for an established business in the marketplace as compared to that same buyer starting a new business. By paying a premium for an established business, the buyer is relying on the existing business's established market share to continue due to such reasons as an established customer base, a premium location, etc.