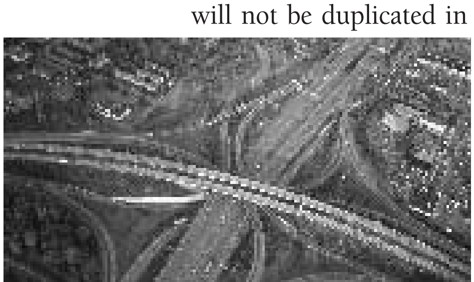
Understanding Goodwill Appraisals

By Patrick M. Millar, ASA

Section 1263.510 of California's Eminent Domain Law authorizes compensation for loss of business goodwill to owners of businesses operating on property taken by condemnation or on the remainder if such property that is part of a larger parcel.

To be eligible for such compensation, the law requires business owners to prove all of the following:

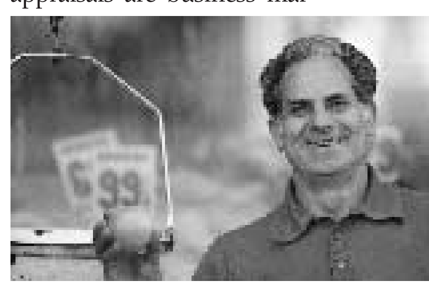
- The loss is caused by the taking of the property or injury to the remainder,
- The loss cannot reasonably be prevented by relocation of the business or by taking steps and adopting procedures that a reasonably prudent person would take and adopt in preserving goodwill,
- Compensation for the loss will not be included in payments under Section 7262 of the Government Code and
- Compensation for the loss will not be duplicated in compensation otherwise awarded to the owner.



Paragraph (b) of Section 1263.510 defines goodwill as, "the benefits that accrue to a business as a result of its location, reputation for dependability, skill or quality, and any other circumstances resulting in the probable retention of old or acquisition of new patronage." This definition was interpreted by many as limiting goodwill to benefits emanating strictly from patronage. That interpretation was later challenged and dismissed in the case of *People v. George H. Muller, et al* (36 Cal.3d 263).

In that case, the California Supreme Court concluded that a loss of goodwill is not limited to loss of patronage, but may also include an increase in expenses or other circumstances that result in reduced profitability and lower goodwill.

Since the passage of California's goodwill statute in 1975, the business valuation community has been quick to provide government agencies and business owners with loss of business goodwill appraisal services and expert testimony. As in most disciplines, the level of expertise and sophistication of goodwill appraisers has increased dramatically since those early years. Today, more and more goodwill appraisers hold advanced business degrees and professional designations in business valuation and/or financial analysis. Nowhere is this heightened level of expertise and sophistication more apparent than in the loss of goodwill appraisal report. Among the topics frequently covered in those appraisals are business mar-



keting, business site selection, consumer behavior, economic conditions, financial analysis, industry conditions, investor behavior, production management, and valuation theory and principles. In addition to covering those topics, the typical loss of goodwill appraisal consists of several often-complex goodwill calculations.

Because of the many elements that comprise a loss of goodwill appraisal, comparing and contrasting opposing goodwill appraisals can be an onerous task for attorneys, review appraisers and right-of-way personnel responsible for negotiating loss of business goodwill claims. For those attorneys and right-of-way professionals who find dissecting goodwill appraisals perplexing, this article offers a helping hand by describing the basic framework for computing lost goodwill and the primary methods for measuring goodwill.

In addition, this article highlights a variety of factors that often account for opposing goodwill appraisers' contrasting loss estimates.

BASIC PROCEDURE FOR CALCULATING LOST GOODWILL

Lost goodwill is calculated by first estimating the amount of goodwill in the business on the valuation date, assuming the condemnation action had never occurred. This is typically referred to as goodwill in the "before" condition and the maximum potential goodwill loss.

Assuming goodwill is found, the next step depends on the business' status at the affected site. If the business can continue operating at that location, an investigation is performed to determine how the condemnation action will affect the company's on-going operations and financial performance. Additionally, the business owner's efforts to mitigate the effects of condemnation must be evaluated in the context of the prudent person standard, which calls for the business owner to take steps and adopt procedures that a reasonably prudent person would take and adopt in trying to preserve goodwill.

If the business cannot remain at the affected property, the scope of the analysis must be expanded to include a relocation study. The purpose of such a study is to confirm that the business cannot relocate in the case of a business that has ceased operating or that management selected the best site for preserving goodwill in the case of a business that has or will be relocating. Depending on the type of business being appraised and the complexity of its site requirements, the services of other professionals such as an industrial engineer, real estate agent, real estate appraiser and relocation specialist may be required to address relocation related issues that are outside the goodwill appraiser's expertise.

The final step in the analysis is to determine the amount of goodwill remaining in the business after condemnation. Except for businesses that could not reasonably relocate, this final step is much like the first step in that the business' future earnings are estimated and incorporated into one or more valuation models to arrive at goodwill. Lost goodwill is simply the difference between goodwill in the "before" condition and goodwill in the "after" condition.

METHODS FOR MEASURING GOODWILL

There are two primary methods for determining the existence and value of business goodwill. They are the excess earnings method and the residual method.

Excess Earnings Method

The excess earnings or "formula" method was developed by the U.S. Treasury Department in 1920 as a means for quantifying the goodwill that breweries and distillers lost due to prohibition. In 1968, the Internal Revenue Service updated and restated excess earnings method in the form of Revenue Ruling 68-609. In doing so, the IRS cautioned that " ... the 'formula' approach may be used for determining the fair market value of intangible assets of a business only if there is no better basis therefore available." Despite the foregoing warning and a series of journal articles published in the early 1980s that echoed similar sentiments, the excess earnings approach continues to be used, especially in condemnation proceedings.[12]

The theory underlying the excess earnings method is that business owners look first to earning a reasonable return on their investment in tangible assets. If the business is able to generate a return over and above that from its tangible assets, the excess earnings are assumed to flow from the company's intangible assets including goodwill. Accordingly, the value of the intangible assets and goodwill can presumably be calculated by capitalizing the excess earnings. The steps involved in computing goodwill and other intangible assets under the excess earnings method are as follows:

1. Separate the company's operating from non-operating assets.

Lost goodwill is calculated by first estimating the amount of goodwill in the business on the valuation date, assuming the condemnation action had never occurred.

2. Determine normalized operating earnings.[3 4]

3. Determine the value of the company's operating tangible assets.

4. Determine a reasonable rate of return on operating tangible assets.

5. Multiply the reasonable rate of return by the value of tangible assets to arrive at the reasonable dollar return on tangible assets.

6. Determine excess earnings by subtracting the return on tangible assets from normalized operating earnings.

7. Determine the capitalization rate appropriate for the excess earnings.

8. Determine the value of intangible assets by dividing the capitalization rate into the excess earnings.

The following example illustrates how the excess earnings method works. Assume that Joe's Machine Shop generates normalized operating earnings of $200,000 after a reasonable salary for Joe, its owner.[5] Let us also assume that the business has tangible assets with a fair market value of $1,000,000 and that a reasonable rate of return on tangible assets and a reasonable capitalization rate on intangible assets are 12 percent and 25 percent, respectively. Under that scenario, the machine shop's goodwill would be computed as follows:

	Normalized Operating Earnings	$200,000
(–)	Return on Tangible Operating Assets	-$120,000
	($1,000,000 x 12%)	
(=)	Excess Earnings	$80,000
(÷)	Excess Earnings Capitalization Rate	25%
(=)	Fair Market Value of Goodwill and Other Intangibles	$320,000

Residual Method

The residual method views goodwill as a valuable asset for which an investor is willing to pay. This value is over and above the fair market value paid for tangible and other identifiable intangible assets. To determine goodwill under the residual method, the fair market value (FMV) of the entire business must first be determined.

Once that value is established, the FMV of the business' tangible assets (working capital, fixtures and equipment, long-term investments) and identifiable intangible assets (favorable supply contracts, leasehold interests, licenses, patents, etc.) are deducted to arrive at goodwill. The basic formula for the residual approach is as follows:

Overall Business Value
(–) Value of Tangible Assets
(–) Value of Identifiable Intangible Assets
(=) Goodwill

Because condemnation proceedings generally involve the taking of smaller, closely held businesses and market sales of small businesses are difficult to identify and verify, the income approach is commonly used for arriving at overall business value. The theory underlying the income approach is that an investor will pay no more for an asset than the present value of the future benefits he/she could expect to derive from holding that asset. The most recognized methods for valuing a business under the income approach are the capitalization of benefits method and the discounted future benefits method.

The capitalization of benefits method arrives at value by dividing a single measure of expected benefits by a capitalization factor. Algebraically, the capitalization of benefits method can be expressed as follows:

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$$\text{Value} = \frac{\text{Expected Benefits}}{\text{Capitalization Rate}}$$

The discounted future benefits method arrives at value by first forecasting benefits for several periods. Once forecast, the future benefits are discounted to present value and summed to yield a value. The formula for the discounted future benefits method is shown below.

$$\text{Value} = \frac{\text{Benefits}^1}{(1+d)^1} + \frac{\text{Benefits}^2}{(1+d)^2} + \frac{\text{Benefits}^3}{(1+d)^3} + \ldots + \frac{\text{Benefits}^\infty}{(1+d)^\infty}$$

Where: d = discount rate or expected rate of return

Both the capitalization of benefits method and the discounted future benefits method quantify benefits in monetary terms. Common measures of benefits include, but are not limited to, earnings before depreciation, interest and taxes (EBDIT), earnings before interest and taxes (EBIT), pre-tax income, net income after taxes and net cash flow.

Just as the excess earnings method uses rates of return to determine expected earnings from tangible assets and the capitalized value of intangible assets, the capitalization of benefits method and discounted future benefits method use rates of return to convert expected benefits into value. The rate of return used in the discounted future benefits method represents the return that prospective investors would require to invest in the subject business. Factors affecting that rate include the current level of interest rates, rates of return available on alternative investments and the subject company's risk characteristics.

The capitalization of future benefits method uses the same rate with an offsetting deduction for future growth. This adjustment is necessary because expected growth is not factored into estimated benefits in the capitalization of future benefits method, whereas it is in the discounted future benefits method.

To illustrate how the residual method works, return to the example of Joe's Machine Shop. In addition to the assumptions mentioned above, assume that Joe's earnings are expected to grow 4 percent per year and that a reasonable rate of return on an investment in the company is 20 percent. Under that scenario, the company would have a capitalization rate of 16 percent, an overall business value of $1,250,000 and goodwill of $250,000. (see top right)

Normalized Operating Earnings	$200,000
(÷) Capitalization Rate (20% - 4%)	16%
(=) Overall Business Value	$1,250,000
(–) Fair Market Value of Tangible Assets	$1,000,000
(=) Goodwill	$250,000

As the two examples show, the excess earnings and residual method can produce different goodwill values for the same level of expected income.

FACTORS CONTRIBUTING TO DIFFERENCES OF OPINION

It is quite common for opposing goodwill appraisals to arrive at significantly different opinions of lost goodwill. While part of that difference may stem from the use of different valuation methods, the bulk of the difference generally results from a few conflicting assumptions and/or conclusions. With that in mind, the remainder of this article highlights a variety of factors and issues that opposing appraisers often assess differently in calculating lost goodwill.

Calculation of Goodwill Before Condemnation

In calculating goodwill before condemnation, opposing goodwill appraisers often make distinct assumptions with respect to the following items:

• **Adjustments to Past Sales** - Regardless of the valuation methodology employed, goodwill appraisers will adjust a company's historic sales to remove any effects of condemnation. For example, if the company being appraised lost sales because a key customer operating on an adjoining parcel was acquired earlier in the condemnation process, then the subject company's historic sales would be adjusted upward to remove the effects of that loss. Occasionally, opposing appraisers will disagree as to if and when condemnation activities adversely affected sales prior to the valuation date.

• **Expected Sales Growth -** All things being equal, higher sales growth translates into higher goodwill. Appraisers frequently disagree about a company's growth prospects based on their analysis of historic sales growth and assessment of economic conditions, industry conditions and project influences.

• **Reasonable Owner's Compensation -** When calculating goodwill, appraisers almost universally adjust owner's compensation to market levels. This is in keeping with generally-accepted appraisal practice and IRS Revenue Ruling 68-609, which states that if the business is a sole proprietorship or partnership [*P. Millar note*: or other type of business for that matter], there should be a reasonable amount deducted from the earnings of the business for the services performed by the owner or partners engaged in the business. As wages and salary data have become readily available via the Internet and other sources, disputes about market wages and salaries have become less common. Nevertheless, disputes still occur, especially when the business owner fills a variety of positions or claims to work only part time.

• **Level of Discretionary and Non-recurring Expenses -** Because discretionary and non-recurring expenses are excluded from the calculation of normalized earnings, higher discretionary and non-recurring expenses translate into higher goodwill, all other things being equal. Disputes over discretionary and non-recurring expenses may arise when one appraiser is willing to accept management's word regarding the nature and dollar value of discretionary and non-recurring expenses while the other is not.

• **Fair Market Rent -** In condemnation proceedings, businesses are compensated for their real property interests through the real property settlement. Consequently, goodwill appraisers impute a fair market rent for businesses that own the underlying fee or have a favorable lease. Goodwill appraisers also impute a fair market rent if the business leases real property from a related party at unrealistic terms. Quite often, opposing appraisers will have different fair market rents due to their reliance on different real estate appraisals.

• **Treatment of Income Taxes -** Disputes over income taxes commonly occur when the subject business is a profitable corporation whose owner(s) have historically avoided paying income taxes by extracting profits in the form of executive compensation, perquisites or discretionary expenses. In that situation, the business' goodwill appraiser may take the position that income taxes are irrelevant since a prospective buyer would likewise minimize income taxes in that same fashion. Conversely, the agency's appraiser may argue that income taxes are relevant because an owner who minimizes income taxes in that fashion, subjects him or herself to IRS scrutiny and potential penalties.

• **Rates of Return** - Comparing capitalization rates and/or discount rates across goodwill appraisals is a fairly straightforward matter if the two appraisers have used the same method(s) to value goodwill and have relied on the same measure of earnings in their calculations. On the other hand, if the appraisers have used different valuation methods and/or earnings measures, then the rates must be adjusted to a comparable basis for any comparison to be meaningful. For example, it would be inappropriate to compare a pre-tax capitalization rate to an after-tax capitalization rate and vice versa. As pointed out earlier, factors affecting that selection of discount rates include the current level of interest rates, rates of return available on alternative investments and the subject company's risk characteristics. A fourth factor, growth, comes into play in the determination of capitalization rates. If two appraisers have different rates, then each must have a different assessment of one or more of the foregoing factors.

Reasonable Efforts to Mitigation

As pointed out earlier, business owners seeking compensation for lost goodwill under California Eminent Domain Law have a duty to mitigate the loss by relocating their businesses or by taking steps and adopting procedures that a reasonably prudent person would take and adopt in trying to preserve goodwill. Because of the myriad of factors involved in finding and selecting a suitable business site, particularly for larger retail establishments and manufacturing concerns, it is not unusual for opposing goodwill appraisers to differ on this issue. Differences of opinion are most common when the business owner seeks to use condemnation as a means of cashing out or acquiring larger facilities for future growth. Differences are also common when the agency and its goodwill appraiser take an aggressive stance and try to assert that the business should have relocated or found more practical facilities even though the agency's relocation staff did little to help the business find a replacement site before and at the time of the taking.

In addition to disagreeing about the reasonableness of the owner's relocation efforts, opposing goodwill appraisers often disagree as to the reasonableness of the business owner's other efforts to mitigate the effects of the taking. Normally, these disagreements center on the business' ability to mitigate a loss of patronage and/or an increase in expenses.

Effects of Condemnation

In addition to mitigation, goodwill appraisers frequently disagree as to how condemnation has or will affect the subject business' patronage, operating expenses, equipment needs, working capital requirements, investment risk, etc. Factors commonly disputed include:

• **Loss of Patronage -** While opposing appraisers will usually agree that a business has suffered a loss of patronage due to condemnation, they seldom agree on 1) how much of that loss is attributable to condemnation activities as opposed to other factors such as industry downturn or increased competition, 2) what portion of the loss is permanent versus temporary and 3) what portion of the loss, if any, will be offset by patronage from new customers.

• **Owner's Involvement** - Business owners often indicate a need to work extra hours after relocation to rebuild their businesses. For example, they may work extra hours pursuing lost customers, seeking new customers, or reestablishing manufacturing processes. Occasionally, opposing appraisers disagree on the owner's need to commit extra hours to the business in view of the reduced workload created by condemnation, and the length of time the owner will have to work extra hours.

• **Capital Expenditures -** Most goodwill appraisers in calculating lost goodwill consider tenant improvements and equipment purchases that are necessitated by condemnation and not compensable through the relocation assistance program. Because business owners occasionally upgrade their operations at the time of relocation, opposing appraisers have been known to differ over which expenditures were necessitated by condemnation and which were not.

• **Heightened Investment Risk -** When computing goodwill following relocation, some appraisers add an additional risk premium to their pre-condemnation rate of return to account for the business' heightened risk at its new location. Other appraisers will use the same rate in both instances, arguing that expected earnings after condemnation have the same chance of materializing as earning prior to condemnation.

Summary

Because of the complexity of loss of goodwill appraisals, comparing and contrasting opposing goodwill appraisals can be an onerous task. In an effort to make that task a little less painful, this article has described the basic framework for computing lost goodwill and the primary methods for measuring goodwill. In addition, this article has highlighted a variety of factors that often account for opposing goodwill appraisers' contrasting loss estimates. ■

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