The Appraisal of an Appraisal Company

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Abstract

At some point, real estate appraisers may consider selling their firm, buying another, or bringing in or buying out partners. At these moments, appraisers will want an appraisal of their appraisal company. The appraisal of an appraisal company is a business valuation exercise and importantly different from real property appraisal. This article examines the appraisal of appraisal companies from the perspective of business valuation. We will explain the methodologies and procedures that represent best business practices and discuss a range of valuation inputs. The discussion is focused on the valuation of small and midsize appraisal firms.

Introduction

At some point, the owners and partners of a real estate appraisal company may look to sell their firm, buy another, or change partners. At these moments, the appraiser will want an appraisal of the appraisal company. Given the current demographics of the real estate appraisal industry, where about 66% of practitioners are over 50 years of age,[1] there will likely be a great number of sales of interests in appraisal firms in the next decade. While experienced real property appraisers may be leaders in their specific areas of practice, their practice experience does not necessarily prepare them fully to appraise their own businesses. The appraisal of an appraisal company is a business valuation exercise that has important differences from real property and personal property appraisal. Even with that distinction, most commercial real property appraisers will recognize the basic business appraisal exercise.

The following discussion examines appraisal company appraisals from the perspective of business valuation theory and practice. The methodologies and common procedures that represent rigorous and best business-appraisal practice will be explained. The broad range of valuation inputs from the market is identified, both for comparable industries and specifically for appraisal companies. Lastly, the process of selling a small business like an appraisal company is examined. Keep in mind, the need for an appraisal of an appraisal company may be occasioned not only by sale of the business but also by settlements in estates, divorces, and litigation.

The Nature of Appraisal Companies

Appraisal companies or firms are best categorized as professional services firms, similar to accounting, legal, engineering, architectural, and real estate brokerage firms and management companies. Such companies share the following significant traits.

Traits of Appraisal Services Companies

Revenue is generated by expert human capital—the appraisal staff. Appraisers and appraisal firms generate revenue by selling expert knowledge, not by selling tangible products or lower-skill services. Revenue is not materially generated by tangible assets, such as real property or machines used to generate products (e.g., steel mills) or services (e.g., restaurants), or from intangibles such as contracts (e.g., property rents) or copyrights (e.g., software), although these assets may contribute to company expenses such as

1. Appraisal Institute, "2023 US Valuation Profession Fact Sheet," available at https://bit.ly/3vRjmzY. The US appraiser population statistics were derived from the Appraisal Subcommittee (ASC) National Registry data from December 2019 to December 2022.

overhead. Appraisal companies rarely have subscription income or perennial contracts.

In appraisal firms, the requisite expert human capital requires training and experience to develop. There are requirements for entry and advancement, such as prerequisite education, licensing, and professional designation. It may take a while for a new appraiser to learn enough to be sufficiently productive to justify their expense to the firm and start adding value to the firm. The more experts there are in the firm, the more revenue there will be, assuming the experts are in demand. Sometimes the revenue of an appraisal company is closely tied to key appraisers; this is an important business valuation factor called the "key person" issue.

Appraisers occasionally charge hourly rates for consulting in addition to charging flat fees for appraisal reporting. Appraisals, once written, are very rarely resold unlike, for example, software code that once written can be resold many times. The appraiser must write new appraisals to generate more revenue. In this way, appraisers are akin to custom home builders whose revenue is limited by how many homes they can build in a year. Appraisers are not like landlords, whose revenue is disconnected from the number of hours the landlord works. Appraisers basically trade hours for dollars. Since there is a limit to fees and hourly rates, there are natural limits to appraisal incomes.

Payroll is leading expense. The flip side of revenue from a human capital business model is that a major portion of the revenue from clients is paid out as expenses for appraisal staff salaries and commissions. At professional services firms, the human capital expense is typically the largest expense of the firm by far. The human capital expense is frequently classified as an operating cost, but it may be useful to think of it as a cost of goods sold. Remember that the total cost of this human capital is not just salaries and commissions; it also includes payroll taxes, health insurance, education expenses, personal time off, severance, and all other perquisites and employee-related expenses. For income tax reporting and management purposes, appraisal staff can be independent contractors and/or employees.

Low capital investment. Appraisal companies require only modest real estate, machinery, or other expensive capital investments. Appraisers typically rent minimal amounts of office space and buy ordinary common computers and office furnishings.

Low-to-no debt financing. Since there is little capital investment, debt financing is also typically low or nil. Appraisal companies are not purchased or owned like homes with high loan-to-value ratios, and companies generally are not funded with bank financing or corporate bonds. Appraisal companies operate with minimal business lines of credit, typically for temporary cash flow issues. If not paid in cash at closing, after-purchase payouts to the firm seller are frequently funded from company operations.

Good profit margins. Professional services firms such as appraisal companies have few expenses after the human capital expense, leaving more to the profit than many other industries.

Slow-growth business. Since revenue is largely dependent on staff, revenue growth may be limited to the potential to add staff. If there is enough work to justify hiring an additional staff appraiser, then there is revenue growth. Finding and developing that human capital, however, can be costly and time consuming. Thus, growth at appraisal companies is slow, rarely explosive, and rarely constant over the long term.

Growth also can be achieved by developing a reputation, which may be classified for valuation purposes as goodwill.[2] But, this too is slow to develop and gives rise to the previously mentioned "key person" issue.

Of course, some appraisers manage to increase revenue per appraiser by differentiation. The classic distinction among real estate appraisers is by property type (residential, commercial, industrial) and by geographic differentiation. Some firms have topical differentiations, such

2. *Goodwill*, in appraisal, is defined distinctly from the common language sense of having a good reputation. Technically, goodwill is the remaining value after all other assets comprising a business have been identified and appraised. It is comprised of unidentifiable intangible assets. See Appraisal Institute, *The Dictionary of Real Estate Appraisal*, 7th ed. (Chicago: Appraisal Institute, 2022), s.v. "goodwill."

Exhibit 1 Professional Services Firms Employment Data

NAICS Descriptions	No. of Firms	Employment	Employees per Firm	Annual Payroll per Employee
Offices of Real Estate Appraisers	12,660	34,143	2.70	$63,506
Offices of Lawyers	160,378	1,071,071	6.68	$105,946
Accounting, Tax Preparation, Bookkeeping, and Payroll Services	118,080	1,188,550	10.07	$64,121
Architectural Services	20,805	181,321	8.72	$83,965
Engineering Services	45,421	1,157,258	25.48	$96,997

Offices of Real Estate Appraisers

Enterprise Employment Size	No. of Firms	Percentage of Firms	Employment		Employees per Firm	Annual Payroll per Employee
0–4	11,514	91%	15,928	47%	1.4	$48,887
5–9	734	6%	4,614	14%	6.3	$62,915
10–19	258	2%	3,321	10%	12.9	$70,634
20–99	109	1%	4,062	12%	37.3	$83,583
100–499	23	0%	3,063	9%	133.2	$87,881
500+	22	0%	3,155	9%	143.4	$81,152
Total	**12,660**	**100%**	**34,143**	**100%**	**2.7**	**$63,506**

Source: Census Bureau 2020 NAICS, release date March 31, 2023.

as hospitality or office property appraisers, or appraisals for litigation, property taxes, condemnation, or government or accounting appraisals. But once moved into the broader categories, additional growth in revenue will be mostly limited to the potential to grow staff.

Key person dependency. At many professional services firms, clients and reputation are tied to individuals within the firm. The firm's value is related to the value that those key individuals bring to the firm. Appraisal companies are often led by one or a few high-reputation, high-value individuals. The individuals' names, not the company's, to a large degree may be the driving force behind the firm's cash flow. When such individuals separate from the firm, the firm's value frequently declines by the value of the separated individuals. The decline may occur over time, as the key person's reputation may linger to the benefit of the firm for years. In some appraisal contexts, the concept of personal goodwill may apply, and the concept may overlap with key person issues.

Size. One of the more important requirements in business appraisal is matching the size of the subject firm and comparables when considering market data. Unlike real estate values, business values by any unit of comparison increase significantly with size. Company size in business appraisal is not a reference to a physical measure but rather a financial measure of income to value. As Exhibit 1 shows, professional services firms generally are small businesses, and most appraisal companies tend to be very small. There are only a handful of large appraisal firms. The large firms generally often grew larger by acquiring smaller firms and by pursuing aggressive growth goals. The valuation of these larger firms is substantially different from the valuation of smaller firms, even though the larger firms regularly buy the smaller ones. This article is focused on the valuation of the small and midsize appraisal firms.

Business structure and income taxes. Few appraisal companies are organized as C-corporations or S-corporations. Most are sole proprietorships, partnerships, limited liability companies (LLCs),

or limited liability partnerships (LLPs). Frequently the appraisal of larger businesses is based on the income stream after income taxes. The appraisal treatment of taxes in C-corporations and S-corporations is extremely complex and is beyond the scope of this article. Fortunately, that appraisal complexity is avoided for the valuation of a typical appraisal firm. The appraiser of appraisal firms and small businesses can frequently complete the appraisal with analyses of pre-income-tax income only. When after-income-tax analyses are needed for an appraisal firm, which is not entirely uncommon, the highly complicated issues of C-corporations or S-corporations are rare. That still leaves the need for the appraiser to be competent with basic and intermediate after-income-tax analyses.

Risk to appraisal companies. There are several main causes of risk to appraisal firms. One risk is loss of leading clients or types of clients. Some firms have but a few clients accounting for most of their work. Some firms have clients from only one or a few categories, such as lenders. Some firms specialize in one type of appraisal, such as appraisal for income tax issues. Competition, changes in regulations, and economics can cut off or reduce demand from these major clients and client types. For example, during national financial crises, lenders often reduce demand for appraisals, which causes income to appraisers to decline substantially. While the appraisal industry usually follows general business and real estate industry cycles, on some occasions it does not. In 2023, the Federal Reserve raised interest rates, which consequently lowered demand for appraisal services.

Some other risks to firms include professional liabilities and appraisal regulations. In recent years, federal agencies have been moving to reduce the need for appraisals by changing the regulatory thresholds for when an appraisal is needed. This would lower demand.

Another major risk to appraisal companies is from the loss of key persons. Often the income of the company is tied to the presence of key individuals who, if they should leave the firm, will take substantial income (clients) with them.

In addition, advancements in artificial intelligence (AI) have accelerated concerns about appraiser displacement. However, it is not clear when and how this will occur. AI is currently not impacting appraisal firm valuation, but it is being examined as possibly an advantageous tool in appraisal research, analysis, and writing that could enhance services.

Business Appraisal Methodologies

Business appraisal uses the same basic approaches to value as real estate appraisal: sales comparison, cost, and income approaches. However, there are distinct variations of these three basic approaches within business appraisal. The variations have names that real estate appraisers may not recognize. The following list shows the business appraisal methods commonly used to appraise professional services firms, such as appraisal companies.

Common Business Appraisal Approaches to Value

- Asset-Based Approach (analogous to cost approach)
- Market Approach (analogous to sales comparison approach in real estate appraisal)
  - Comparable Transaction Approach
  - Guideline Public Company Approach
  - Employee/Professional Multiplier Approach
- Income Approach with various income multiplier approaches
  - Discounted Cash Flow Approach
  - Before and/or After Income Taxes Income Approaches

Asset-Based Approach

An asset-based approach in business appraisal is similar to the cost approach in real estate appraisal. In real estate, the cost of the building is added to the value of the land to find the total real estate value. In the asset-based approach, the value of the various items of machinery and equipment are determined, along with the value of other assets in the business, and then they are added to the real estate values to find the total value of the business.

Notably, many techniques typically used in real estate appraisal or in business appraisal of other types of businesses are not commonly used in the appraisal of small professional services firms. Business appraisal theory teaches that since there are few tangible assets and few separately sellable assets at appraisal companies, the cost approach

(asset-based approach) is not probative to value. The most important asset of appraisal companies, its expert staff, is not an asset that the cost approach and the asset-based approach are best suited to appraise.

Market Approach

Comparable transaction approach. A market approach, also known as a transaction comparison approach, is commonly used within business appraisal, and it is practical for use when valuing appraisal firms. The unit of comparison is often value/price per employee or professional. Sales of similar companies are researched. Then, the sale prices are converted into a price per employee or professional. Adjustments are considered and applied, and then a value per employee or professional for the subject is concluded. This is conceptually very similar to the traditional sales comparison approach used in the appraisal of real estate. Similar pros and cons arise with this technique relative to the other approaches.

Multiplier approach and rules of thumb. Various rule-of-thumb reference guides are used by some market participants to informally evaluate small companies such as appraisal companies. However, rigorous business appraisers view rule-of-thumb guides as notoriously imprecise, and they give little or no weight to rule-of-thumb indications of value. The issue with rules of thumb is that the basis of the rules comes from personal experience, hearsay, and/or averages or tendencies that the appraiser cannot analyze. The problem with the blind use of rules of thumb for business valuation is equivalent to the problem with a real estate appraiser taking a market average sale price from a CoStar market report and applying that market average to a subject without adjusting for any differences between the sales that comprise the market average and the subject. The source data for the averages and for typical multipliers is not verifiable. This leaves the reader of the appraisal without any means to review the rule-of-thumb data. If market data is available for the comparables used to develop a rule of thumb, then the technique can be reformed into a more reliable approach. For example, some brokers sell appraisal companies using the following rule-of-thumb multiples: 0.5 × sales revenue, 2.0 × seller's discretionary cash flow, 5.0 × EBITDA (earnings before interest, taxes, depreciation, and amortization). However, without details about these multiples, another appraiser could not adopt these for any given subject company. Also, depending on the source of the rule of thumb and who is using it, these may fail net opinion rules for expert opinions. An appraiser may not be able to draw credible or reliable conclusions about any specific firm using rules of thumb without analyzing and presenting the basis for the rules of thumb. Rules of thumb generally do not come with the data on which the rules were based. Without such data, there would be inadequate information on which to make appraisal judgments and to determine whether the subject is better, worse, or the same as the comparable companies that were the basis for the rules of thumb.

The danger of inaccuracy is easily spotted within the wide range of possible multipliers reported in the Exhibit 2 example. The exhibit also presents an example of valuation under various possible multipliers. Such a wide range of indications of value is common in business appraisal, perhaps more so than in real estate appraisal. However, that is not an excuse for inaccuracy or incomplete analysis. In short, it is simply not appropriate appraisal practice to opine that the typical or average multiple—or the low or the high multiplier—is suitable unless the appraiser has completed appropriate research and analysis to determine that the selected multiplier is correct for the subject. Note the excessive imprecision in the range of values in Exhibit 2. After a full analysis of the industry, the subject company, and the individual sales that make up the rule of thumb, an appraiser can frequently find a basis to conclude a specific and well-founded multiplier. After that full analysis, the appraiser also can often find a basis for adjustments to the typical multipliers for value-impacting differences between the comparables and the subject. This sound business appraisal practice avoids the pitfalls of the rote use of rules of thumb.

Guideline public company approach. Since appraisal companies are generally not publicly traded and tend to be very small, the guideline public company (GPC) approach is typically not used. Appraisers execute a GPC method by identifying publicly traded companies—which tend to have very large market capitalizations—that are comparable to the subject company in important value-impacting ways. The appraisers analyze the GPC comparables and extract various multipliers

and benchmarks that are then compared to and applied to the subject. The various multipliers and benchmarks include various income and expense ratios, debt/equity ratio, and other valuation multipliers. Analysis of the subject industry and the various GPC benchmarks indicates which of the valuation multipliers are best in the subject's case. That, in turn, is used to determine a value.

GPC data may also be used in other approaches to value. Exhibit 3 presents data on several publicly traded professional services firms that offer appraisal services among other services. This kind of data helps in identifying the characteristics of the industry and in reconciliations.

Exhibit 2 Example of Problematic Use of Rule-of-Thumb Multipliers for Appraisal Companies

	Sales Revenue	Seller's Discretionary Cash Flow	EBITDA
Range of Multipliers			
Low Multiplier	0.25	1.50	3.00
High Multiplier	0.90	3.50	12.00
Typical	0.67	2.25	6.00
Valuation Using Rule-of-Thumb Multipliers			
Assumed Income	$1,000,000	$297,778	$111,667
Problematic Typical Range of Value			
Low Value	$250,000	$446,667	$335,000
High Value	$900,000	$1,042,222	$1,340,000
Range of Values	360%	233%	400%
Typical Value	$670,000	$670,000	$670,000
Difference from Low Value	268%	150%	200%
Difference from High Value	134%	156%	200%

Notes:

Sales Revenue = Value (market value of invested capital, equity, and debt) divided by seller's discretionary cash flow (SDCF) or seller's discretionary earning, or company earnings before interest, taxes, depreciation, and amortization (EBITDA) after adding back seller's compensation at company, and sometimes other adjustments, equals SDCF multiplier.

SDCF = Value (market value of invested capital, equity, and debt) divided by seller's discretionary cash flow (SDCF) or seller's discretionary earning, or EBITDA after adding back seller's compensation at company, and sometimes other adjustments, equals SDCF multiplier.

EBITDA = Value (market value of invested capital, equity, and debt) divided by EBITDA equals EBITDA multiplier.

Income Approach

Discounted cash flow. Since appraisal firms' future cash flows are not prescribed by contracts, or do not follow predictable patterns, a discounted cash flow (DCF) analysis is not usually employed. With that said, the appraiser of an appraisal firm will frequently need to address two changing income circumstances. First, some firms are growing income, such as younger firms that are establishing their reputation and/or moving into new areas of practice. Second, income will likely decline if there is a departure of a key person. A DCF analysis can be employed in these circumstances; however, business appraisers typically will instead make adjustments to normalize forecasted incomes and/or to the income multipliers, or they will make post-value-computation adjustments.

While the issues of rules of thumb discussed previously must be recognized, it is ultimately the case that multiplier analyses are the leading approach to appraise small businesses but only when completed correctly. Below is a list of references for both rules of thumb and more rigorous sources for multipliers.

Multiplier and Rule-of-Thumb Databases and References

- DealStats (formerly Pratt's Stats) and Bizcomps, from Business Valuation Resources
- Risk Management Association Annual Statement Studies
- S&P Capital IQ
- Bizcomps, from ValuSource
- Business Reference Guide

The income approaches commonly used for small professional services firms are multiplier techniques. Real estate appraisers will be familiar with gross rent or gross income multiplier techniques, which are essentially the same types of analyses in theory. Tradition has real estate appraisers switching to capitalization rates when analyzing net incomes and cash flows. Alternatively, business appraisers by tradition continue to apply multipliers to net incomes and cash flows. Remember that a capitalization rate is simply the inverse of a multiplier. Capitalization rates (or multipliers) must be precisely matched to the income level they are being applied to or else a fatal appraisal error will occur. The gross income capitalization rate (or multiplier) that is

Exhibit 3 2022 Benchmarks from Publicly Traded Professional Firms Offering Appraisal Services

Company	No. of Employees	Gross Revenue per Employee	MVIC per Employee	MVIC/Gross Revenue Multiplier
Cushman Wakefield	53,000	$190,598	$110,816	0.58
CBRE Group Inc.	115,000	$269,960	$234,376	0.87
Newmark Group	6,500	$416,235	$244,615	0.59

Note: Technically, this table presents the market value of invested capital (MVIC), which equals the sum of the market value of outstanding equity shares at currently exchanged prices, plus the amount of the reported long-term and short-term debt.

appropriately applied to a *gross* income is not the appropriate capitalization rate (or multiplier) to apply to a *net* income or a cash flow. There are at least as many commonly used income levels in business appraisal as in real estate appraisal; the most common ones are listed in Exhibit 4.

One traditional difference between business valuation and real property valuation is that the former employs income approach methods that regularly compute incomes after income taxes. Since appraisal companies are commonly LLCs/LLPs, partnerships, or sole proprietorships, many complex income tax valuation issues that arise with C-corporations and S-corporations are avoided. Nonetheless, sometimes after-income-tax income approaches are used for small business appraisals, such as the appraisal of small appraisal businesses. These analysis types are seen in the last two rows of the list in Exhibit 4.

Exhibit 4 Commonly Capitalized Income Levels for Appraisal Companies

Leading methods are shown in blue.

Income Level		Multiplier
Gross Sales Revenue	×	Gross Sales Revenue Multiplier
Net Sales Revenue	×	Net Sales Revenue Multiplier
Gross Revenue	×	Gross Revenue Multiplier
Gross Profit (Revenue less Cost of Goods Sold)	×	Gross Profit Multiplier
Seller's Discretionary Cash Flow (SDCF)	×	SDCF Multiplier
EBITDA	×	EBITDA Multiplier
EBIT	×	EBIT Multiplier
Net Income (after income taxes)	×	Net Income Multiplier
Cash Flow (after income taxes)	×	Cash Flow Multiplier

Income Approach Process

Step 1: Income Normalization. The business appraiser must normalize the financial statements of the subject firm and comparable companies. This normalization (stabilization) process is the same concept as in real estate appraisal, except that there are more line items in the income and expense statements to be normalized in business valuation, such as income taxes and working capital. The challenges in normalization of income projections in business appraisal should not be underestimated. In many respects, the normalization of income is more difficult in business appraisal than in real estate, because real estate income and expenses are more predictable, especially when income is prescribed by long-term leases. In contrast, businesses can have combinations of assets (real property, personal property, business intangibles), can have incomes and expenses that each change at their own rates, and can have anomalies in the historical records.

Typically, business appraisers will examine either the prior year's income and expenses, or the last three years, or both. However, it is not uncommon to analyze additional combinations of historical years. The selection of the number of years to analyze depends on the nature and growth expectations of the business and its income stabilization characteristics. If older historical years do not represent current and future levels of income, business appraisers will de-emphasize older historical years, and may use only the more recent year's income.

One question in business appraisal that is not commonly encountered in real estate appraisal is

the issue of matching the period of a multiplier with the period of the normalized income. Income forecasts and multipliers can be for either the trailing twelve months or last twelve months (TTM or LTM) or the next twelve months (NTM). The notion here is to avoid applying a TTM multiplier to a NTM income, and vice versa. The appraisal theory is that if the multiplier is based on comparable data of the TTM, then the income and matching TTM already reflect the market-anticipated appreciation or depreciation. In real estate, most income capitalization analyses are conducted on NTM income and rates/multipliers. While a valid concept for consideration, the appraisal problem at hand will often eclipse the significance of TTM versus NTM issue, such as when the subject company has anticipated income growth that is substantially different from what the comparables are expecting, or when there are other valuation issues of greater magnitude.

Business appraisers will spend significantly more time than real estate appraisers interviewing the management of the small business to uncover the special value-impacting issues within the business, its financial statements, and details about the industry. It is not uncommon for business appraisers to have multiple follow-up data and information requests and several interviews.

Step 2: Comparable Selection. The appraiser must choose comparable companies for derivation of multipliers. In business appraisal, the comparable companies are referred to as "guideline," "peer," or "competitive" (private or public) companies. This is analogous to comparable selection in any real estate appraisal. Data on comparable multiplier companies is just as scarce as it can be for real estate comparables. The task of finding comparable business sales and multipliers may leave even the experienced real estate appraiser uneasy with the results.

Step 3: Multiplier Analysis. The appraiser then calculates the multiples at the comparables, and then adjusts the multipliers, reconciles them, determines the most credible multipliers, and applies those credible multipliers to the subject company. The reconciliation, selection, and application step is where appraisal imprecision frequently arises. To improve precision, substantial insight and experience help separate comparable multipliers between those that are probative and indicative of value for the subject and those that are not. The best practice is to compare numerous financial ratios between the subject firm and the comparables, and to give less weight or no weight to those comparables with substantive dissimilarities. This will be discussed later.

Step 4: Reconciliation. The appraiser reconciles these multiplier indications, of which there may be multiple multiplier indications, with all other indications to conclude a value.

Step 5: Post-Value Computation Adjustments. Lastly, the appraiser considers the necessity of applying discounts or premiums to the value for as-of-yet unaddressed issues, such as partial or minority interests (discount for lack of marketability and discount for lack of control), contractual conditions, or other issues not accounted for in the normalization of financial statements or in multiplier selection or reconciliation.

So far, the discussion has largely addressed direct capitalization techniques. At this point, the appraiser may need to consider a DCF, if the appraiser was not able to account for developing business opportunities or threats in either the income normalization steps or in the selection of a multiplier.

Financial Ratios and Comparable Companies

The best way to discern applicable multipliers or sales comparables among potential comparable companies is to compare the financial ratios of the subject and comparable companies. There are dozens of financial ratios. Some are better for certain types of companies, such as large companies, fast-growing companies, asset-intensive companies, inventory-intensive companies, highly leveraged companies, and high-inventory companies, but these ratios do not inform the analyst much about the typical appraisal firm. The most common financial ratio indicators are listed in Exhibit 5; the ratios shown in blue are more likely to be useful for typical appraisal firms.

While the following is presented as typical within the last several years, note that there was a decline in financial performance (Exhibit 5) and in valuation multipliers (Exhibit 6) during the COVID-19 pandemic. Data from the quarters immediately after the pandemic suggested that a recovery was underway. However, because of the interest rate increases in 2023, multipliers for

Exhibit 5 Common Financial Ratios

Financial Ratio	Description	Typical Range for Appraisal Firms
Sales/Professional (or Employee)	Sales or Gross Revenue per Professional (or Employee)	See Exhibit 6
Gross Profit Margin	Gross Profit/Net Sales	67% to 75%
SDCF Margin	Discretionary Earnings/Net Sales	20% to 75%
EBITDA Margin	EBITDA/Net Sales	10% to 50%
Operating Profit Margin	Operating Profit/Net Sales	5% to 15%
Net Profit Margin	Net Income/Net Sales	3% to 15%
Return on Assets	Net Income/Total Assets	
Return on Equity	Net Income/(Total Assets – Total Liabilities)	
Fixed Charge Coverage	Operating Profit/Interest Expense	
Long-Term Liabilities to Assets	Long-Term Liabilities/Total Assets	
Long-Term Liabilities to Equity	Long-Term Liabilities/(Total Assets – Total Liabilities)	
Current Ratio	Total Current Assets/(Total Liabilities – Long-Term Liabilities)	
Quick Ratio	(Total Current Assets – Inventory)/(Total Liabilities – Long-Term Liabilities)	
Total Asset Turnover	Sales/Total Assets	
Fixed Asset Turnover	Sales/Fixed Assets	
Inventory Turnover	Sales/Inventory	

appraisal firms may decline in the short term. It is worth noting that multipliers remain largely level over the longer term, changing only slightly due to major, broader economic conditions.

Comparisons between Appraisal, CPA, and Law Firms

Since data in appraisal, whether of real estate or businesses, can be scarce, it is probative to examine data from analogous circumstances for which there is more data. For appraisal companies, this means comparisons to professional services firms in architecture, engineering, accounting, and law. Exhibit 6 presents multipliers for these other professional services firms with sales less than $5,000,000 but over $250,000.

Nonoperating, Operating, and Excess Assets/Liabilities and Income/Expenses

Appraisal companies have few tangible assets. As such, they have little chance of having excess or nonoperating assets—that is, assets that are not essential to the current operations of the firm. If a firm did, the effects of those assets would need to be excluded from the analysis of the going concern. As always in real estate or business appraisal, if the financial records include personal incomes or expenses that are mingled within the business records or include incomes and expenses that are otherwise not transferable to the next owner, then those incomes and expenses must be removed from the normalized forecast. Excess or nonoperating assets may have value as independent assets but are not part of the economic unit of the going concern. If a firm has liabilities, incomes, or expenses that are separable and independent of the going concern, these liabilities, incomes, or expenses must be excluded from the appraisal of the going concern. For example, a firm owner's personal car loan and insurance premiums ought to be excluded from the appraisal of the going concern. Depending on the client's appraisal needs, these assets and liabilities may need to be appraised separately.

Seller's Discretionary Cash Flow

Seller's discretionary cash flow is also known as seller's discretionary earnings. As always in appraisal, it is important to confirm that all parties are working with the same definitions because

Exhibit 6 Multipliers for Appraisal Firms and Other Professional Services Firms

	Sales Revenue Multiplier	Seller's Discretionary Cash Flow Multiplier	EBITDA Multiplier	Net Sales / No. of Employees	Value / No. of Employees
Appraisal Firms					
Low	0.25	1.50	3.00	$75,000	$50,000
High	0.90	3.50	12.00	$300,000	$250,000
Typical	0.67	2.25	6.00	$175,000	$125,000
Other Small Professional Firms: Accountants, Attorneys, Engineers, Architects					
Low	0.25	1.00	1.00	$50,000	$25,000
High	1.50	5.00	8.00	$500,000	$400,000
Typical	0.85	2.25	3.50	$150,000	$125,000

variations are not uncommon and there are often no official or statutory definitions.

It frequently occurs that salaries and prerequisites to equity owners are in excess (or short) of market terms in the financial statements. While this is appropriate record keeping for accounting purposes, in appraisal, where the goal is to reflect market terms, this needs to be excluded from the appraisal. There are two ways to do so. The appraiser can replace the excessive (or short) terms with market rate compensation. Then the appraiser would apply a multiplier to the income level that reflects the deduction of equity owner's compensation. Or the appraiser can exclude all owner's compensation from the income computation but then must apply the proper multiplier to that level of income, namely a seller's discretionary cash flow multiplier, as this is known. This later method is common in the appraisal of small professional businesses.

Other Transaction Terms

Similar to descriptions of real estate leases—where it is misleading to merely quote a rent without also describing the lease as net or gross, the annual rent changes, free rent, and work letters—business transactions have numerous terms and conditions that could impact the value conclusion. Business value conclusions must be accompanied by an understanding of who (buyer or seller) gets the assets or liabilities and which ones and when. For example, the value of an appraisal firm is different depending on who gets to keep the payments for outstanding invoices (accounts receivable) from before the appraisal date. The following are some terms of sale that must be specified as part of a business valuation.

Sales Terms and Conditions

- Accounts receivable and accounts payable
- Working capital accounts (checking and savings accounts)
- Excess and nonoperating assets and liabilities
- Potential or pending litigation
- Insurance beneficiaries
- Noncompete terms
- Time-release payouts
- Contingent payouts

Example Analysis of an Appraisal Company

The table in Exhibit 7 presents a traditional income multiplier analysis of a fictitious appraisal firm. To normalize the income forecast, the appraiser notes that, except for the COVID years of 2020 and 2021, gross income was stable. Therefore, the appraiser concluded that the technique of averaging out the last three to five years of income and expenses as the basis of the forecast would not be appropriate. The appraiser could have used the common technique for limiting the analysis to the trailing twelve months, TTM. The appraiser opted for an analysis of the years before and after COVID and to also reflect the impacts of inflation.

It is important to note that the definitions of the various income streams are not uniform

among analysts. For example, the net income shown in Exhibit 7 is before deduction of interest and depreciation, which many analysts do. It is good practice to confirm the working definitions. Further, notice that this company incurs no capital expenses, and therefore has no depreciation or amortization because all purchases are expensed in the year of purchase. This means that the net operating income (NOI) is the same as the NOI after capital expenses.

Detailed interviews with management and ownership reveal that reported salary expenses include some compensation to ownership. The appraiser would need to describe this in the report, because this will impact the value based on the EBITDA multiplier and because the appraiser will need to adjust the SDCF. The interviews also reveal that an adjustment to the SDCF is needed for car and insurance expenses for the owner that are not customary in the market and are not strictly speaking expenses of the business.

The appraiser gathered various multiplier data from the market. That research revealed several multipliers from comparable companies. The appraiser researched and analyzed comparable companies and their multipliers. The appraiser considered the differences between the comparables and the subject company and concluded on the use of three different multipliers tailored for the subject.

In the reconciliation, the appraiser would review the quality of the data in each multiplier analysis. The appraiser would note which is preferred in the marketplace—usually the SDCF analysis and the gross revenue analysis for stable companies. In detailed analyses, the appraiser would research and analyze the applicable financial ratios of the subject relative to the multiplier of comparable companies and to other market data, benchmarks, and financial ratios. The appraiser would also reconcile with the other approaches completed, such as a market (sales comparison) approach and other market data and benchmarks, such as value per professional or per employee. Exhibit 8 presents a typical analysis of an income proforma, a like-kind analysis. All dollars are expressed as a percentage and related to gross income.

In the post-value calculations, the appraiser identified two significant issues: a key person issue and a partial interest issue. The key person issue was considered substantial because there are no golden handcuffs, payouts, or earnouts. The key person was expected to depart the firm promptly after the sale. The appraiser conducted the research and made an adjustment for this issue. This adjustment could have been made within the income normalization forecast. The partial interest was addressed separately with a discount study to determine the discount for lack of control and for lack of marketability.

Process of Selling or Buying an Appraisal Business

All appraisers know that price may not equal value. Even good appraisers may forget this principle, however, as personal emotions creep in during sale of a firm. It is important to remember that as many as 70% of offered small businesses will never sell, and that as few as 30% of family businesses get handed down. It is unwise to hold out for the proverbial last dollar or to assume a family transfer is the exit plan. With that said, appraisers should be prepared with their completed homework and begin the negotiations. Research currently suggests that large and small private firms that sell typically sell for between 80% and 90% of the asking price, taking between 100 and 225 days to sell.

Business owners can help prepare years in advance by considering and aligning the pool of potential buyers and examining each: partners, senior staff, family, local appraisal firms, national appraisal firms, or accounting/consulting firms. The most aggressive buyers typically expect synergy or strategic advances from the deal, have market leadership, have enthusiasm for the deal, and have financial wherewithal. Such buyers will pay the most and are most likely to close a deal. Appraisers should prepare their client contacts over the preceding years for the buyer's use. In the year preceding the sale, prepare the business's records. Acquirers may choose to maintain a list of prospects and to foster relationships in advance, as closing a deal is assisted with already established trust and understanding.

Potential trouble spots. The following are issues that cause deals on small professional practices to fail:

- bad real estate leases
- poor professional liability insurance
- unwanted assets or obligations
- contingent liabilities and lawsuits
- sloppy accounting
- lack of enthusiasm for the deal

Exhibit 7 Example of Income Multiplier Analysis

($,000)	2018	2019	2020	2021	2022	2023 Forecast	Multiplier	Indicated Value	Value per Professional
Appraisal Services	$1,594.1	$1,668.3	$1,223.9	$934.8	$1,672.8	$1,810.0			
Consulting Services	$285.4	$156.2	$113.2	$193.1	$183.3	$229.0			
Payroll Protection Plan	$0.0	$0.0	$0.0	$216.0	$0.0	$0.0			
Gross Revenue	**$1,879.4**	**$1,824.5**	**$1,337.0**	**$1,343.9**	**$1,856.1**	**$2,039.0**			
Credit Loss/Write-Off	–$1.0	–$19.0	–$3.0	–$12.0	–$29.0	–$18.0			
Adjusted Gross Income	**$1,878.4**	**$1,805.5**	**$1,334.0**	**$1,331.9**	**$1,827.1**	**$2,021.0**	**0.67**	**$1,350.0**	**$225.0**
Salaries and Benefits	$947.5	$968.8	$842.5	$803.8	$1,135.0	$1,120.0			
Payroll Taxes	$41.0	$47.0	$46.0	$46.0	$46.0	$49.0			
Payroll and Payroll Expenses	**$988.5**	**$1,015.8**	**$888.5**	**$849.8**	**$1,181.0**	**$1,169.0**			
Subcontractors	$43.0	$10.0	$88.0	$25.0	$20.0	$27.0			
Cost of Goods Sold	**$1,031.5**	**$1,025.8**	**$976.5**	**$874.8**	**$1,201.0**	**$1,196.0**			
Gross Profit	**$846.9**	**$779.7**	**$357.5**	**$457.2**	**$626.1**	**$825.0**			
Auto Expense	$5.0	$7.0	$8.0	$6.0	$5.0	$6.0			
Insurance Expenses	$75.0	$75.0	$102.0	$87.0	$114.0	$97.0			
Office Rent	$36.3	$47.5	$51.3	$48.8	$47.5	$48.0			
All Other Operating Expenses	$336.0	$346.0	$292.0	$293.0	$306.0	$362.0			
Expenses	**$452.3**	**$475.5**	**$453.3**	**$434.8**	**$472.5**	**$513.0**			
Net Operating Income/EBITDA	**$394.7**	**$304.2**	**–$95.7**	**$22.4**	**$153.6**	**$312.0**	**4.50**	**$1,400.0**	**$233.3**
Depreciation & Amortization	$0.0	$0.0	$0.0	$0.0	$0.0	$0.0			
Interest Expense	$0.2	$0.3	$2.0	$4.0	$1.0	$1.0			
Taxable Income	**$394.5**	**$303.9**	**–$97.7**	**$18.4**	**$152.6**	**$311.0**			
Taxes, Income	**$174.0**	**$109.0**	**$72.0**	**$211.0**	**$49.0**	**$49.0**			
Cash Flow	**$220.7**	**$195.2**	**–$167.7**	**–$188.6**	**$104.6**	**$263.0**			
Sellers Compensation	**$250.0**	**$275.0**	**$150.0**	**$150.0**	**$300.0**	**$300.0**			
Auto Expense	**$2.5**	**$3.5**	**$4.0**	**$3.0**	**$2.5**	**$3.0**			
Insurance Expenses	**$4.5**	**$4.5**	**$4.5**	**$4.5**	**$4.5**	**$4.5**			
Add Backs for Sellers Discretionary Income	**$257.0**	**$283.0**	**$158.5**	**$157.5**	**$307.0**	**$307.5**			
Sellers Discretionary Income	**$651.7**	**$587.2**	**$62.8**	**$179.9**	**$460.6**	**$619.5**	**2.25**	**$1,390.0**	**$231.7**

Note: The numbers in this table are fictitious. The ratios and values that result may not represent real market conditions.

Exhibit 8 Typical Analysis of an Income Proforma

	2018	2019	2020	2021	2022	2023 Forecast
Appraisal Services	85%	91%	92%	70%	90%	89%
Consulting Services	15%	9%	8%	14%	10%	11%
Payroll Protection Plan	0%	0%	0%	16%	0%	0%
Gross Revenue	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**
Credit Loss/Write-Off	0%	–1%	0%	–1%	–2%	–1%
Adjusted Gross Income	**100%**	**99%**	**100%**	**99%**	**98%**	**99%**
Salaries and Benefits	50%	53%	63%	60%	61%	55%
Payroll Taxes	2%	3%	3%	3%	2%	2%
Payroll and Payroll Expenses	**53%**	**56%**	**66%**	**63%**	**64%**	**57%**
Subcontractors	2%	1%	7%	2%	1%	1%
Cost of Goods Sold	**55%**	**56%**	**73%**	**65%**	**65%**	**59%**
Gross Profit	**45%**	**43%**	**27%**	**34%**	**34%**	**40%**
Auto Expense	0%	0%	1%	0%	0%	0%
Insurance Expenses	4%	4%	8%	6%	6%	5%
Office Rent	2%	3%	4%	4%	3%	2%
All Other Operating Expenses	18%	19%	22%	22%	16%	18%
Expenses	**24%**	**26%**	**34%**	**32%**	**25%**	**25%**
Net Operating Income/EBITDA	**21%**	**17%**	**–7%**	**2%**	**8%**	**15%**
Depreciation & Amortization	0%	0%	0%	0%	0%	0%
Interest Expense	0%	0%	0%	0%	0%	0%
Taxable Income	**21%**	**17%**	**–7%**	**1%**	**8%**	**15%**
Taxes, Income	**9%**	**6%**	**5%**	**16%**	**3%**	**2%**
Cash Flow	**12%**	**11%**	**–13%**	**–14%**	**6%**	**13%**
Sellers Compensation	**13%**	**15%**	**11%**	**11%**	**16%**	**15%**
Auto Expense	**0%**	**0%**	**0%**	**0%**	**0%**	**0%**
Insurance Expenses	**0%**	**0%**	**0%**	**0%**	**0%**	**0%**
Add Backs for Sellers Discretionary Income	**14%**	**16%**	**12%**	**12%**	**17%**	**15%**
Sellers Discretionary Income	**35%**	**32%**	**5%**	**13%**	**25%**	**30%**

Value and sale price. There are almost always considerations beyond getting the full market value when selling or buying an appraisal firm. While appraisers typically focus on market value, sometimes in a sale of an appraisal firm other values ought to be determined. If purchasing a particular appraisal company provides a strategic advantage or synergy to the buying company, then investment value ought to be examined, and paying a price above market value can make good business sense. Business appraisers often describe the "buy a job" deal. While sometimes not being the best financial action relative to otherwise normal transactions, some buyers of small businesses appear willing to exceed market multiples and benchmarks to buy an income stream that merely matches a salary, but with no premium for the business entrepreneur. While perhaps not a market-rate transaction, buying a job may represent a value in use.

If delaying the sale is delaying other pursuits or other business initiatives, then value in use ought to be considered, and perhaps selling for less than market value is wise. While less likely in the sale of an appraisal firm, both buyers and sellers may have tax considerations that would justify departure from a typical market value sale price. With that said, estate tax and management considerations often impact sale price decisions. Recognizing when the client needs something other than or in addition to market value is essential to business valuation consulting. Understanding these and other values may bridge understanding gaps from the acceptable price to market value and may reduce insecurity to levels sufficient to close the deal.

Risk. Potential buyers should examine the risk profile of the appraisal firm and sellers should work to reduce any risk. It is not just about estimating income. Identify the leading sources of appraisal income and the leading clients and determine which are at risk. To the extent possible, enter into noncompete agreements with key employees and get long-term contracts with clients. Offer or demand golden handcuffs for key persons. Identify any intellectual property or geographic advantage or appraisal specialty that creates value or that may be at risk.

Appraising businesses in divorce, litigation, and partition situations requires adaptation. The context not only affects the definition of value, but it also frequently affects the premise of value, an uncommon issue in general real estate appraisal. Local law may have prescriptions for the consideration of goodwill, key person considerations, and noncompete clauses, and for discounts for marketability and control. Early first steps in these appraisals may need to include consulting with legal and accounting counsel.

Conclusion

In the next decade, many real estate appraisers will need a business appraisal for their own businesses. As always, informed consumers fare best. Real estate appraisal practices differ from business appraisal practices, but much of the methodology will appear familiar. With a little help, a careful real estate appraiser can easily understand a business appraisal of an appraisal firm and might even be able to draft such an appraisal themselves.

SEE NEXT PAGE FOR ADDITIONAL RESOURCES >

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Additional Resources

Suggested by the Y. T. and Louise Lee Lum Library

Appraisal Institute

- **Lum Library, Knowledge Base [Login required]**
  - Business value
  - Professional practice: Divorce, matrimonial dissolution
  - Value in use
- **Publications**
  The Appraisal of Real Estate, fifteenth edition