REALTRENDS
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VALUING
SMALL- TO MEDIUM-SIZED BROKERAGE COMPANIES

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EXECUTIVE SUMMARY

REAL Trends annually ranks the largest brokerage companies in the United States in the REAL Trends 500 and Up-and-Comers report. The report covers residential brokerage firms that closed more than 500 sides in a calendar year. Approximately 1,800 residential brokerage firms are included in this annual report.

According to the National Association of Realtors® and other sources, there are about 85,000 to 110,000 residential brokerage firms in the United States. It's clear that the majority of residential brokerage firms close fewer than 500 transactions annually.

We know that the REAL Trends 500 and Up-and-Comers report only accounts for approximately one-third of all transactions. That means that the tens of thousands of small- and medium-sized brokerage firms collectively account for the rest—or two-thirds of all transactions.

REAL Trends has performed over 3,000 valuations of residential brokerage firms in its 32 years and handled the sale of more than 745 brokerage firms in that time. While most of the transactions we've handled have been among firms doing more than 500 transactions, we've also assisted several hundred firms doing less than that volume.

32
years
3,000+
valuations
745+
transactions

How these small- to medium-sized brokerages are valued is critically important.

In many cases, their financial results do not fit neatly into the Income Approach to valuation. Thankfully, there are other methods that we use to value such firms. The Gross Margin Approach is commonly used for small- to medium-sized firms. However, there are other factors that are not frequently considered.

This book is meant to be used by both small- and medium-sized brokerage firms as a guide to how they are generally valued, as well as a guide for their owners to know how best to create value.

REAL Trends has always had a policy that the first call to us for input and guidance on valuation, merger and acquisition activities is **free and comes with no commitments by the brokerage firm other than our promise of total confidentiality**. Our first and only goal is that residential brokerage firm owners have access to the experience and knowledge of our team of four valuation, merger and acquisition experts with a combined 38 years' experience.
There are a variety of reasons that have nothing to do with the sale of the firm. They include some of the following:

WHY DO BROKERAGE LEADERS HAVE VALUATIONS DONE?

- Partnership/shareholder disputes and issues
- Buy-sell agreements
- Estate issues
- Gifting of shares to trusts or family or non-family executives
- Litigation
- Stock ownership
- Bankruptcy or other legal actions
- Marital dissolution

REAL Trends has performed valuations for all of these reasons and others as well. One key part of our valuation report is that we also provide a Benchmark Report that compares the firm being valued with its peer group of other brokerage firms in terms of revenue, expenses, profit and measures of productivity.

DETERMINING VALUE

There are two recognized approaches to valuing a residential realty firm. They are:

- The Income Approach (EBITDA)
- The Gross Margin or Company Revenue Approach

The ***Income Approach*** is the most widely used approach to value in both the residential brokerage industry and many others. It's also recognized in most legal jurisdictions and by professional valuation organizations throughout the United States.

The ***Gross Margin or Company Revenue Approach*** is an approach specific to the residential real estate industry and is used when a firm has little earnings performance or is a small firm (less than $2 million in gross revenues). It's also used when the owner contributes a material portion of the revenues, or income, of the firm.

While there have been other approaches used at various times in the past 30 years, these two approaches are used by nearly all buyers, whether they're national, regional or local and without regard to the size of the brokerage.

THE INCOME APPROACH

The *Income Approach* is the most commonly used method for valuing a residential real estate services business, including realty, mortgage, title and escrow services. It's sometimes referred to as the EBITDA (earnings before interest, taxes, depreciation and amortization) approach. In this report, we'll refer to it as the *Income Approach*.

The *Income Approach* first determines the income from the business over a certain period and then applies a ***multiple*** of that income to determine value.

The most common period used for calculating EBITDA is the most current 12 months of the company's operations.

Items included in/added back to income for the purposes of this approach are:

- Profit before income taxes
- Depreciation
- Operating interest expense (interest on business operating accounts and not interest on buildings or personal assets owned by the owner and carried on the balance sheet of the Company)
- Amortization
- Owners' compensation and benefits
- Non-recurring expenses (ex., expenses to open offices, temporary labor, legal settlements, etc.)

Items deducted from the income and considered chargebacks are:

- Comparable costs of management (see definitions in Appendix)
- Non-recurring income (gain on the sale of assets, legal settlements, etc.)
- Interest or dividend income
- Owners' commission contribution to revenue net of any commission paid to the owner

These items are added back or deducted from income to determine the EBITDA of the firm for a determined period. For the past 20 years, this has been the most current 12 months of results. Some valuators use an average of the last two to three years of these results.

A multiple is then calculated against this income to determine the value of the firm. The multiples vary according to market conditions, location and the size of the firm, as well as other factors that will be discussed further.

EXAMPLE:

A firm has the following results based on the most current 12 months profit and loss statement.

INCOME ITEMS

Net income before taxes	$100,000
Depreciation	$ 10,000
Amortization	$ 2,000
Interest expense	$ 5,000
Owners' compensation and benefits	$150,000
Non-recurring expense	$ 5,000
Total Income Items	**$272,000**

CHARGEBACKS

Comparable cost of management	$125,000
Owner's contribution to revenue	$ 50,000
Non-recurring income	$ 0
Total Chargeback Items	**$175,000**

Firm Income	**$97,000**

MULTIPLE FOR VALUATION

The next step is to determine the multiple to apply against this income. For this example, we use a three (3) multiple. The adjusted income of the firm is multiplied by the *multiple* to arrive at a proposed value. For our example, this results in the following:

Income	**$ 97,000**
Times the multiple (by example only)	**3**
Equals Total Value of Firm	**$291,000**

Once this value is determined, there are other factors that may affect the outcome. Some factors that may affect final value include the terms of the transaction, the relationship of the sellers with the buyers going forward with the firm after a sale, and non-compete agreements.

THE GROSS MARGIN OR COMPANY REVENUE APPROACH

The Gross Margin or Company Revenue Approach is used mostly for firms that have little or no earnings or are small firms to medium-sized companies and/or where the owner contributes a material portion of the revenues of the firm.

The Gross Margin or Company Revenue Approach examines the company's revenue over a period, most often the last 12 months of operations.

Gross Margin or Company Revenue is the sum of revenue which is retained by the firm after payment of all costs related to sales. Such costs as commissions to the firm's sales associates, referral fees to outside sources, co-brokerage fees to outside brokerage firms and franchise fees are deducted from Gross Revenues to determine the Company Revenue figure.

Once the Gross Margin or Company Revenue figure is determined, a percentage is applied against the figure to determine value.

Example:

A firm has the following results:

Gross Commission Revenues or Fees	$1,000,000
Minus cost of agent commissions	-$ 700,000
Equals Gross Margin/Company Revenue	**$ 300,000**

The final step is to use a percentage of the Company Revenue to determine value. For this example, we will use 30 percent.

Gross Margin/Company Revenue	$ 300,000
Percentage Applied (30%)	.30
Equals Total Value of Firm	**$ 90,000**

The percentage used in each case varies widely and is based on factors such as location and size of firm, the position of the selling owners after close, synergy opportunities to the buyers and the terms of the transaction.

COMPOSITION OF THE DEAL:

CASH VERSUS EARNOUT

100 percent cash transactions at the Fair Market Value at the time of closing are virtually non-existent in the residential brokerage industry.

Virtually every merger or acquisition of a residential brokerage company is based on a percentage of the Fair Market Value in cash at closing with the remainder most often in the form of an earn-out or contingent payments over a period after closing.

EARNOUT FORMULAS

An earnout is a contingent payment based usually on the retention of the agents and their production over the period of time of the earnout. Its main purpose is to incent the seller of a brokerage firm to remain available and present for the agents of the seller and to transfer their relationships to the new owner.

The most common formula used in earnouts is the following:

$500,000
Last twelve (12) months Gross Margin

$150,000
Purchase price

$50,000
Cash

$100,000
Amount remaining to be paid

3
Years of earnout

THE FORMULA IS:

$100,000

÷

$500,000

÷

3

=

6.67%

The dollar amount of the earnout divided by the last 12 months gross margin divided by the years of the earnout.

The earnout is 6.67% of the gross margin generated by the agents of the seller for a period of three years. The payments most often are paid quarterly, semi-annually or annually.

CURRENT VALUATIONS

Residential brokerage values have decreased from where they were in 2017 and early 2018. The reasons for this are a decline in housing sales, overall softness in the resale and new home market, rising mortgage rates and a highly competitive environment for the recruitment and retention of productive sales agents.

Generally, for firms closing fewer than 500 transactions per year (or roughly $300 million in sales volume), the prices available in the market are as follows:

INCOME APPROACH

EBITDA **X** 2-3

GROSS MARGIN APPROACH

Gross Margin **X** 20-35%

Cash down as a percent of the Fair Value of a residential brokerage firm ranges from 15 to 30 percent for small- to medium-sized brokerage firms.

The remainder is in the form of an earnout over a period —generally three to four years.

KEY ISSUES RELATING TO VALUATION OF SMALL- TO MEDIUM-SIZED BROKERAGE FIRMS

One of the most important factors is the role of the owner of a small- to medium-sized brokerage firm.

The owners of these firms often have strong relationships with the firm's employees and sales agents, contribute a material amount to the Gross Revenues from commissions (generally over 10% of company total), often leave most of their Gross Revenues or Commissions in the company and are running various expenses through the company as a matter of convenience.

When an owner of a small- to medium-sized brokerage firm contributes more than 10% of the Gross Revenues through their listing or sales activity, it's normal to exclude that business from the valuation exercise.

Another way to handle it is to recalculate the Gross Margin or Company Revenue by placing the owner on the same commission program as any one of their agents at a similar level of sales production. In our experience, this is prevalent, and owners of such firms need to be aware that significant, material adjustments are often made.

10 KEY FACTORS THAT INFLUENCE VALUE FOR SMALL- AND MEDIUM-SIZED BROKERAGE FIRMS

- Terms of the Transaction
- Location of the Firm
- Size of the Firm
- Operating Similarities of the Buyers and Sellers
- Retention and Position of the Owners/Sellers After a Sale
- Affiliation with a National or Regional Franchise Organization or Brand
- Concentration of Sales
- Legal Structure of Sellers
- Consistency of Results
- Depth and Breadth of Market for Firm

Terms of the Transaction

Simply put, the more the buyers pay in cash at close, the more risk the buyers assume in the transaction. Therefore, the less they may be willing to pay. On the other hand, when sellers can give more generous terms (less cash at close, more time to pay off obligations), it's likely that the seller will receive a higher price.

Maximum value for sellers is achieved when both parties have some risk in a transaction. The optimal terms are usually a modest portion of cash at closing with a two- to four- year earnout contingent payment to the sellers.

When sellers seek to achieve an all-cash transaction, buyers usually determine that there's either too much risk in the transaction or that the sellers are worried about something that causes them to seek all cash. In either case, buyers usually lower prices when the sellers seek no risk after the close of a transaction.

Location of the Firm

The location of a firm does have an impact on value. When a firm is in a major metropolitan area, with potential synergy with larger local, regional or national realty service a firms, value will likely be higher than for a similarly sized firm in a small rural or suburban community.

Further, when a firm is in a key geographic location within a metropolitan area, has an attractive office location or has an important share of a key market sought after by other firms, then this kind of firm would likely carry higher value than a firm that lacked these attributes.

Size of the Firm

Larger firms usually carry higher values than do firms that are smaller in size. Buyers are interested mainly in growth through acquisition. When the costs of completing a transaction are the same without regard to the size of a firm being acquired, then buyers will usually pay relatively more for a firm that is larger.

Operational Similarities with Buyers

With the variety of realty service firms expanding rapidly over the past 10 years, buyers look carefully at the operational benchmarks of a firm they're interested in acquiring, especially when they're planning to combine the sellers' operations with their own existing operations.

Such factors as the average commission rate charged by the firm, the Gross Margin/Company Revenue percentage rate, policies regarding shared expenses and consumer fees can have an impact on the value of a firm.

By example, when purchasers desire to expand through acquisition in a market, and they have a Gross Margin/Company Revenue percentage of 30 percent, the buyers will not be as interested in a firm that has a Company Revenue percentage of 22 percent. Any combination of two such organizations would be fraught with challenges, and the potential of the loss of sales professionals, as the company with 22 percent is clearly paying more to its agents.

Retention and Position of the Owners/Sellers

Many buyers desire to retain the owners/sellers to assist in the transition and limit the potential loss of sales associates and build good will with the management team of the sellers. In some cases, the sellers continue to have a positive influence on each of these parties.

When owners/sellers desire to remain involved with their firm after a sale, the overall value is often higher. Retaining the owners/sellers reduces risks to the purchasers, potentially raising the value.

Affiliation with a National Brand

Obviously, a national or regional affiliation may bring value to a residential realty services firm during a franchise agreement. However, the value of a firm that is under a franchise agreement may be lower than one that does not have a franchise agreement at the time of the sale.

This is because franchise agreements may limit or restrict the ability of a residential brokerage firm owner firm to sell to parties other than a buyer who will retain the franchise agreement or is already with that particular franchise system.

The value is not so negatively affected at or near the time of expiration of a franchise contract. The effect on value is solely due to the restrictions of a sale included in most franchise contracts by national and regional franchisors.

The restrictions of a sale in these contracts during the duration of the franchise contract reduce the number of potential purchasers. As such, the potential market for the firm is reduced.

Sellers within the same brand have fewer restrictions and value is not impacted as frequently.

Concentration of Sales

Particularly in firms with less than $2 million in Gross Revenues, there's the potential that a small number of sales associates contribute a disproportionate and material part of the Gross Revenues to the firm.

As such, the risk of retention of a few key persons tends to influence the value of a firm. Where concentration does exist, value is usually lower, and when such a concentration does not exist, the value is generally higher.

Legal Structure of Seller

Buyers desire to purchase the assets and assume certain liabilities of sellers. For tax and liability reasons, they prefer not to purchase the stock of the sellers.

Sellers that are formed as S Corporations, LLC or LLP firms or proprietorships can easily sell assets to a purchaser without adverse tax consequences.

Sellers that are formed as C Corporations may suffer significant additional tax liabilities in an asset sale and, in most cases, will not desire to sell assets from a C Corporation.

In many cases, when buyers desire to purchase a firm formed as a C Corporation, they may be willing to buy stock but often do so at a lower price than when they can acquire the assets of the seller through an asset sale.

This is due to buyers losing important tax benefits and the retention of undesirable liabilities when purchasing stock. The result is most often lower valuations for stock purchases than for asset purchases by buyers.

Consistency of Results

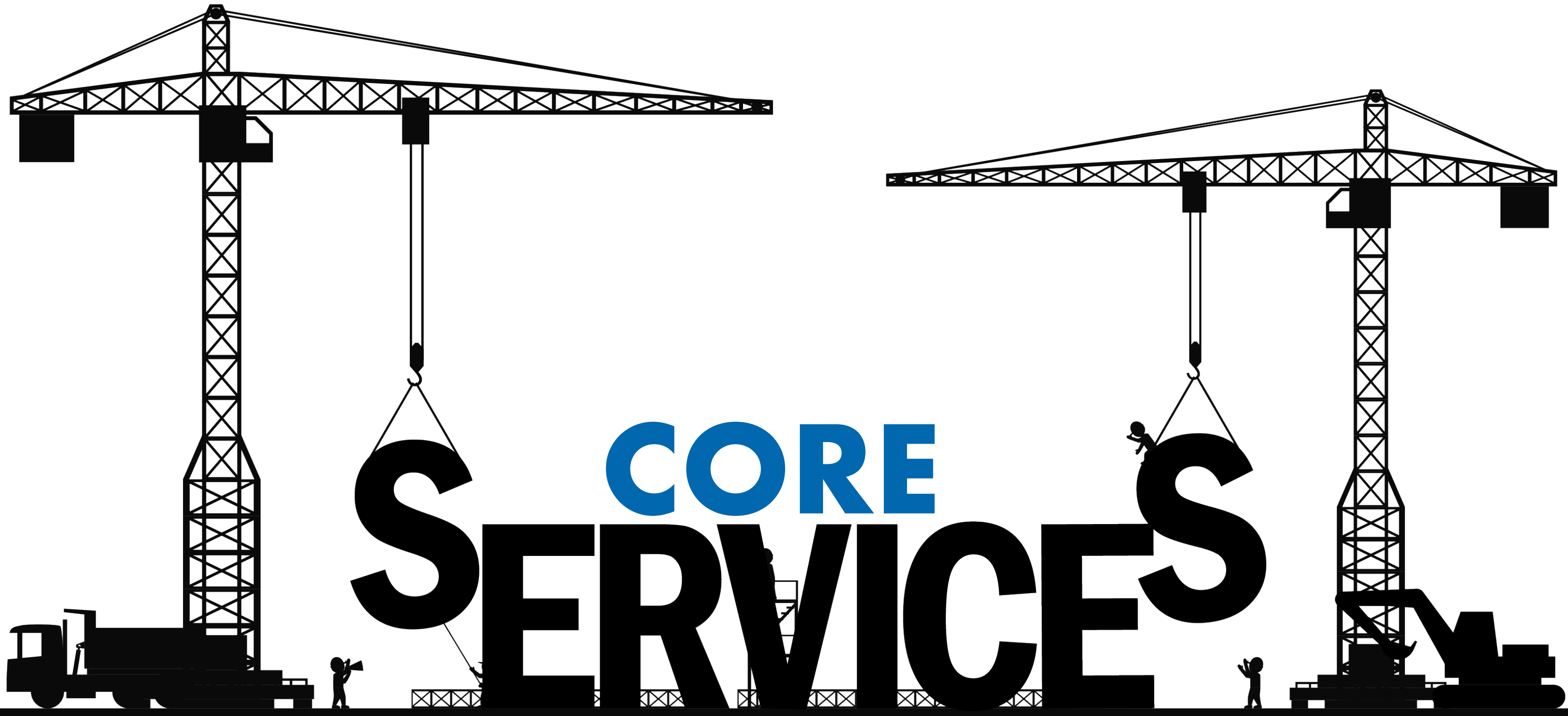
When a firm has uneven results over a period of two to four years prior to a potential sale, buyers will typically either reduce the price they're willing to pay, or they'll lower the cash portion of a deal and increase the earn-out portion of a transaction.

This is the case whether a firm has rapidly rising results due solely to market conditions, or they have uneven results due to less-than-optimal operating discipline.

Purchasers will also examine individual categories of revenues and expenses to determine if one-time events have had a material impact on results in determining value.

Depth and Breadth of Market for Firm

When a firm is in a market where there are two or more qualified and interested buyers, then the value of a firm will be higher than in a market where there's only one potential purchaser.



VALUATION OF CORE SERVICES

Many leading realty service businesses have diversified their service and revenue operations to include mortgage, title insurance, escrow and other products related to the sale and purchase of housing.

In most cases, buyers are interested in acquiring these related service businesses when they acquire a realty business. The valuation approach used most often is the *Income Approach*.

While the approach to determining the income is exactly as it is for realty businesses, multiples vary somewhat. Generally, multiples for mortgage operations are less than those for realty businesses, while title and other related services are near the same level as found for the realty business. This does vary with market conditions, how these core services are operated, and the legal format within which these businesses are organized.

Structure of earnout Agreements

Earnout agreements are the part of a purchase agreement that deals with contingent payments over time between the buyers and sellers. They represent an at-risk portion of the purchase price of transaction.

These earnout agreements are often based on the retention of certain levels of Gross Margin/ Company Revenue in a stated period after the transaction close.

When the sellers can retain the same or higher levels of such revenues for the earn-out period after close, they will receive 100 percent of the earnout payment. When there is a measurable decline in such revenues, then the sellers may suffer some diminution of the total proceeds that they receive.

The portion of a deal covered under an earnout agreement usually doesn't guarantee a minimum level of payment to the sellers. However, in some agreements, a *collar* arrangement is made that both limits the amount sellers can receive under the earn-out agreement while also providing a floor or minimum payment.

Earnout agreements rarely provide for the payment of any interest on the estimated amounts payable under the agreement.

Sellers should be mindful that they may increase the final value of their firm by being more willing to accept broader earnout agreements. This reduces the risk to the purchaser and, as such, buyers are usually willing to value sellers higher than when the sellers are unwilling to accept earn-out payments as part of a transaction.

Comments on Synergy

The benefits of synergy are the property of the buyers and not the sellers. This is due to the buyers assuming risk in cost reductions, office consolidations and other cost-saving moves (synergies) that impact retention or loss of sales associates and sales production.

There are cases when the availability of synergies may result in a higher valuation than would be the case with a similarly sized firm when there are evident synergies to both parties and when the sellers are willing to retain some of the risk of synergistic actions through the earn-out portion of a transaction. However, the sharing of synergistic value from the buyers to the sellers is relatively rare.

ASSETS INCLUDED IN A SALE

The assets included in a sale of a residential realty services business may include the following:

- Listing contracts as of the close date
- Pending contracts as of the close date
- Trademarks, copyrights, names, electronic addresses, such as website URLs and email addresses, phone numbers and fax numbers
- A reasonable non-compete, non-solicitation agreement
- Furniture, fixtures and equipment associated with the operation of the firm

Liabilities usually assumed include:

- Assumption of equipment leases associated with the operation of the firm
- Certain office leases associated with the operation of the firm

Non-Compete and Non-Solicitation Agreements

The value of a firm can be affected by the willingness of the sellers to enter into a non-compete and/or non-solicitation agreements. When the sellers seek to materially limit a non-compete and non-solicitation agreement, buyers are concerned. Sellers who seek to unreasonably limit these may see a decrease in value or the withdrawal of offers.

Most non-compete and non-solicitation agreements have a set duration and geography. A normal duration is three to five years and covers varying areas—usually at least 50 miles from any office location of the sellers.

Non-compete and non-solicitation agreements cover the relationship of the sellers to the future recruitment of or employment of sales associates and employees of the sellers and non-disclosure agreements covering all aspects of the sellers' and buyers' operations that may have been learned while at the firm.

While some people will comment that these agreements are not enforceable, recent court cases suggest that the non-solicitation and non-disclosure portions of these agreements are, in fact, enforceable.


REALTRENDS
THE TRUSTED SOURCE
WHAT'S YOUR BROKERAGE FIRM WORTH?
For over 30 years, REAL Trends has been the leader in valuation services for the residential real estate industry. We've performed over 3,000 valuations and remain The Trusted Source for brokerage firms of all sizes across the country.
What does a valuation provide to you?
• A three-year financial analysis.
• A full narrative report that describes our findings.
• A benchmark report.
• Up to four hours of consulting time.
• Peace of mind!
For more information, please call Scott Wright or Steve Murray at 303-741-1000
or Scott via email at swright@realtrends.com
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WORKSHEETS

Below are outlines that readers may use to estimate an **APPROXIMATE** value of their firm. Recall that multiples used in the Income Approach and percentages used in the Company Revenue Approach vary greatly depending on the factors listed in these pages.

For the purpose of developing the appropriate multiple for the Income Approach and the appropriate percentage for the Company Revenue Approach, please consult REAL Trends.

GROSS MARGIN/COMPANY REVENUE APPROACH	
Gross revenues	$__________________
Cost of commissions	$__________________
Equals Gross Margin/Company Revenue	**$__________________**
Percentage to be applied (20 to 35%)	______%
Percentage times Gross Margin/ Company Revenue Equals Company Revenue Approach	**$__________________**

INCOME APPROACH

INCOME	
Income before taxes	$_______________
+	
Depreciation	$_______________
+	
Amortization	$_______________
+	
Interest expense	$_______________
+	
Owner's compensation	$_______________
+	
Owner's benefits	$_______________
+	
Non-recurring expense	$_______________
Equals total income items	**$**_______________
CHARGEBACKS TO INCOME	
Comparable cost of management	$_______________
+	
Non-recurring expense	$_______________
+	
Owner's contribution to Company Revenue	$_______________
+	
Interest or dividend income	$_______________
Equals chargebacks against income	**$**_______________
Total income items	$_______________
- Less total chargebacks	$_______________
Equals EBITDA or	
Income	**$**_______________
VALUATION	
Income	$_______________
Times the multiple (2 to 3)	X____
EQUALS TOTAL VALUE	**$**_______________

DEFINITIONS

Comparable Cost of Management
This is the cost associated with replacing the owners'/sellers' services to the firm after sale. Comparable Cost of Management will vary from firm to firm and from market to market.

The range of comparable cost of management is from a low of $50,000 to a high of $400,000. One way to measure it is to ascertain how much the sellers would accept as compensation to keep doing what they were doing for the firm for two to three years after closing. This is the surest manner of determining the comparable cost of management.

Cost of Sales
Cost of Sales is referral fees paid to outside sources, commissions paid to cooperating brokerage firms, commissions paid to sales associates and often franchise fees paid to outside firms.

Gross Revenues
The total of revenues from realty operations including commission income, transaction fees, shared expense charge backs to sales associates and other fees charged to sales associates. This may also include some property management fees and consumer transaction fees.

Income Before Taxes
The income shown on the Income Statement of the firm that is normally the total income prior to the payment of Federal and State Income Taxes.

Non-recurring Expenses and Incomes
Non-recurring expenses and income are often an area of contention when discussing valuations. There are no set rules as to what constitutes non-recurring items.

To be qualified as a non-recurring item, it must truly be an extraordinary event, such as a one-time office relocation or opening expense, the expenses due to an acquisition, the permanent reduction of personnel (versus simply laying off people for positions to be filled later), a one-time legal settlement and other truly one-time occurrences.

Owner's Compensation and Benefits
This is the sum of all payments made to the owners for their services to the firm. These payments normally include salaries and wages, bonuses, wage taxes, health insurance, life insurance, disability insurance, auto expense, club dues and payments made to profit-sharing or pension accounts on behalf of owners.

Commissions paid on personal transactions, distributions that are not expensed on the Income Statement, personal travel expenses, gifts or charitable contributions and other normal operating costs of a business leader are not usually included.