



## Excess Earnings Revisited

In an earlier issue, we touched on the excess earnings method. In this issue, we will dive into the method further and discuss the capitalization rate (cap rate) in more detail. I would refer you to an earlier issue if you would like the basics of performing the excess earnings method.

Excess earnings are the earnings that can not be attributed to the assets of the business. It is the earnings that are generated by the intangible assets. I must state that this method can only be used to value the intangible value of the business. To arrive at an opinion of value for the overall business, the excess earnings method must be added to the value arrived at from the adjusted net asset method.

One complication of this method is determining the appropriate cap rate, or defensible cap rate, to be used. How do you go about developing a cap rate to be applied to earnings from intangible assets? This question is the very reason why the cap rate used in the excess earnings method can be, and is challenged. Following, are areas that could be used to help determine the excess earnings cap rate.

1. *The cap rate used in other methods within the income approach.* This is only a place to start, in developing the cap rate for the excess earnings method. Common sense tells us that we can not use a cap rate that was used on a revenue stream that is attributed to both tangible and intangible assets. The cap rate must be in relation to the amount of risk that a buyer would assume.
2. *Rate of return applied to tangible assets alone.* To use the tangible asset rate or the spread between the tangible asset rate and the cap rate would not necessarily be correct. However, it can be used to aid in the development of the excess earnings cap rate.
3. *Quality of excess earnings.* Are the earnings consistent or is there a consistent increase each year? What is the quality of the customer base? Are they loyal or is there a high turnover of clients? How many years of excess earnings has there been? There are many more questions you can ask of the quality of earnings, but I think you get the picture.
4. *The cash flow used in the appraisal.* Much like the cap rate determined for methods within the income approach. The cap rate needs to match the type of revenue stream that is being appraised. This goes back to matching risk with reward.

This is just four areas that you could use to help develop a cap rate for the excess earnings method. They are by no means perfect. In the end, it all boils down to how well the appraiser can defend the process or method used to determine the excess earnings cap rate.

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