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What can add more value to your business than any other thing?

In a word - Goodwill.

What is goodwill? Goodwill is generally described as the ability to earn above average returns on the tangible net assets employed in a business. In other words, you generate more income or cash flows than you would otherwise have expected to generate given the assets in your business.

There are several different types of goodwill; some of these are good for your business and some are bad.

Bad goodwill – kind of sounds like an oxymoron doesn't it? Well it's true, there are indeed some kinds of goodwill that you'd rather not have – at least as far as the value of your business is concerned.

Let's identify some of the types of goodwill you can encounter. Bear in mind that depending on the type of business you have, some will be applicable and some will not.

The kind you want

Goodwill of Location

This is goodwill that accrues to a business by virtue of its physical location. Remember that this value can depend on lease agreements and other things that impact on how long you can stay in that location.

For example, Company A operates a fitness facility on a popular route used by many residents going to and from work. It is near commercial office buildings as well as a large residential area. As a result, this club enjoys a high volume of walk-in customers that are interested in joining the club because of its proximity to either their place of work or their homes. This company is able to earn a return in excess of what is deemed a reasonable rate of return on its net tangible assets, and hence enjoys goodwill of location.

Goodwill of Product

This is goodwill that accrues to a business by virtue of the product identity and acceptance it enjoys in the minds of its customers and potential customers.

For example, Company B manufactures blankets and towels. In particular, its blankets enjoy national recognition. Company B determines profitability by profit centre, one of which is the blanket division. This division has sustainable profits in excess of what is deemed a reasonable rate of return on its net tangible assets, and hence enjoys goodwill of product.

Goodwill of Service

This is goodwill that accrues to a business by virtue of the identity and acceptance of its service in the minds of its customers and potential customers.

For example, Company C offers delivery and installation of office workstations to companies. It has developed a reputation of supplying quality work crews at good value to its customers. Company C has sustainable return in excess of what is deemed a reasonable rate of return on its net tangible assets, and hence enjoys goodwill of service.

The kind you don't want!

Personal Goodwill

This is goodwill that accrues to an individual arising from his or her particular abilities, good name and reputation, which are not transferable by contract or otherwise. Because it is personal in nature it expires at the time the person in question loses interest in their business; retires as a result of personal choice, age, or disability; or dies.

By its nature personal goodwill is not transferable and therefore has no commercial value.

For example, consider a successful heart surgeon with a demonstrated ability. This ability has brought her national fame, presumably significant economic wealth, and a large annual income. That portion of her annual income that accrues from her ongoing operating room success has economic value to her, but is of no value to anyone else. In the event she stopped practicing for any reason, or died suddenly, this income source largely would evaporate. Hence, it has no commercial value.

In practice the value of many small businesses includes a significant portion of personal goodwill. Through the use of employment contracts and non-compete agreements sellers try to convert some of that personal goodwill to saleable goodwill but that isn't always possible. There is a very strong probability that the purchaser will not pay for this type of goodwill. And why should they?

Why would a purchaser pay for something that might not be transferable to them? We can't transfer our reputation, skills or abilities and it is difficult to transfer the relationships we have built up over the years.

So what does this mean? If you want to maximize your return on your business investment you need to minimize your personal goodwill.

How do you do that?

- You work **ON** your business rather than **IN** it;
- You develop systems that can be relied on (not that rely on you);
- You transfer, wherever possible, your skills and knowledge to your team;

- You develop your team to the point where you become redundant.

Your RAN-ONE firm (Cornerstone Business Solutions) can be instrumental in ensuring that your business practices are maximizing your business value through the reduction of personal goodwill and maximizing the commercially saleable goodwill.

Graham Mathew & Partners LLP. This paper is designed to alert members to business valuation developments and should not be relied upon as a substitute for detailed advice or as a basis to formulate business or other fiscal decisions.

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