Rules of Thumb: Do they have a place in business valuation?

For many types of businesses, you can find a rule of thumb for valuing it. Rules of thumb are quick, easy to understand and use, and inexpensive. However, because they’re generally based on industry averages, they fail to capture the specific characteristics of a business that drive its value.

Rules of thumb may offer a rough indication of value that can be used to satisfy a business owner’s curiosity or to serve as a “reasonableness or sanity check” on results derived from other methods. But they’re no substitute for a comprehensive, formal valuation.

What is a rule of thumb?

The International Glossary of Business Valuation Terms defines “rule of thumb” as “a mathematical formula developed from the relationship between price and certain variables based on experience, observation, hearsay, or a combination of these; usually industry specific.”

Typically, rules of thumb are expressed as multiples of revenues or some form of earnings or cash flow. They may also be based on multiples of assets or units of capacity or activity. For example, one rule of thumb for valuing motels is $20,000 per room.

Rules of thumb come from many sources, including business brokers, industry consultants, trade associations, publications and word of mouth. Generally, they apply to small, single-site businesses, though some industries may have them for larger organizations. In both cases, many transactions are needed to yield market-derived price multiples. The best ones are industry- and geography-specific.
What are the disadvantages?

A rule of thumb is a variation of the market approach to valuation. Market-based methods value a business by analyzing valuation multiples from transactions involving similar businesses and making adjustments to reflect the subject’s characteristics. Key to an accurate valuation is access to information to determine whether other companies and transactions are truly comparable and to identify appropriate adjustments.

The problem with rules of thumb is that they’re based on average multiples derived from transactions involving companies that may or may not be comparable to the subject. And, they’re often based on subjective judgment or word of mouth rather than objective sources of verifiable data.

Even if a rule of thumb is derived from solid market data, it’s impossible — without access to details about the underlying companies and transactions — to determine whether the rule has any relevance to the subject company. For example, a common rule of thumb for valuing full-service restaurants is 30% of annual gross revenues. But prices in actual transactions range from well under 20% to well over 100% of gross revenues.

Why such a wide range? It’s because business value is affected by a variety of factors besides revenues, such as gross profits, lease and other expenses, cash flow, growth, location, competition, management strength, and risk. A rule of thumb might produce a reasonable value for a business that’s near the industry average in these areas, but, for businesses that deviate from the norm, rules of thumb are unreliable indicators of value.

Also, rules of thumb generally don’t account for transaction terms. For example, do transactions involve cash purchases or seller financing? Are they stock sales or asset sales? In applying a rule of thumb, should you add real estate and inventory to value? Should you subtract debt? The answers to these questions can have a significant impact on value, but rules of thumb are often silent on these issues.

Last, rules of thumb can be misleading if their terms aren’t defined. If a business is valued at three times earnings, for example, the result can vary dramatically depending on the definition of “earnings.” Does it mean after-tax earnings? Earnings before interest and taxes (EBIT)? Owner’s discretionary cash flow?

Handle With Care

In situations that demand accurate valuations — such as business sales, litigation or tax planning — rules of thumb are no substitute for professional valuations using generally accepted methods. What’s more, rules of thumb used as a major valuation method will not likely survive scrutiny in court. They may be appropriate, however, for developing a rough, preliminary indication of value or for gauging the reasonableness of a

RULE OF THUMB IN ACTION

Let’s look at an example of the inherent weakness of many rules of thumb: Company A and Company B are IT businesses. One rule of thumb for IT businesses is three times earnings before interest and taxes (EBIT). Companies A and B each have $500,000 in EBIT in 2012, so each would be valued at $1.5 million under the rule of thumb.

Suppose, however, that Company A’s EBIT was $75,000 in 2010 and $200,000 in 2011. Company B’s EBIT, on the other hand, was $1 million in 2010 and $750,000 in 2011. Although the rule of thumb values the two companies equally, an informed buyer would likely place a much higher value on Company A, particularly if there’s reason to believe that its pattern of rapid growth will continue in future years.