

Rules of Thumb – It’s Not That Simple

Rule of Thumb: An Italian restaurant should sell for 30% of gross revenue. Valuation completed! Draw up the paperwork, right?

Reducing the complexity of business valuation to rules of thumb is an appealing proposition. Avoiding complex cash flow calculations and side stepping necessary adjustments makes the process of valuation more appealing and more accessible to the lay user. However, one must still deal with the dilemma: “Should it be done simply because it can be done?” Is there value in the simplicity of rules of thumb?

The answer is “maybe.” It all begins with the intended purpose of the valuation. An early retiree seeking a second career might use the methodology to narrow down the number of potential investment selections. The business owner in the initial stage of succession planning may need a number to allow him to work through the steps in the process. The aging parents concerned with equitable distribution when leaving a family business to their children. There are many other examples where a “quick-fix” calculation is a necessary first step to addressing a specific situation. Later, as the process progresses, additional detailed analysis and more sophisticated methodologies can be used to replace the rule of thumb value. The value determined by the rule is simply a bookmark to be replaced at the appropriate time.

Rules of thumb based on actual completed transactions are perhaps the most useful. These types of rules theoretically approximate the Market Comparison Approach. The word “approximate” should be used loosely, as there will no doubt be differences between the subject company and the rule of thumb “average.” These differences include, but are not limited to: expense structure, age of equipment, building lease term, cash flow trends, and specific competition. Equally important are the terms of sale. A rule of thumb based on seller financing likely produces a different result from a rule based upon a cash purchase premise.

How does the rule address inventory, real estate, and debt? Unless the rule specifically states how these issues are addressed, one cannot know if they are accounted for in the rule. Is inventory and real estate added to value? Is debt subtracted from value? The answer to either question can impact value dramatically.

Yes, rules of thumb are quick and simple. If properly understood and applied correctly, they can be useful in some valuation situations. Unfortunately, the only thing certain about their use is the uncertainty as to the comparability to the target situation. A single formula cannot address all of the company-specific differences. Furthermore, users should be aware that rules of thumb from different sources are not necessarily comparable. The source of the rule is important. Independent, professional sources utilizing data based on completed transactions would more likely provide market-driven rules.

Rules of thumb are useful. The source of the rule must be identified and the underlying assumptions understood. Professional business valuers can assist in determining the appropriate application of a specific rule in a given situation.