Rules of Thumb Don't Reveal the Whole Picture

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VR Mergers & Acquisitions customarily use the cost, income and market approaches when valuing a business. But where do less scientific metrics - like industry rules of thumb - fit into the valuation paradigm.

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."

Rules of thumb serve as useful sanity checks for controlling interests valued using more technically sound methods. However, VR staunchly believes that they should not be used as the sole method of valuation for several fundamental reasons:

They're unsupported. Not to be confused with the market approach - which derives valuation multiples from customized empirical data and in-depth statistical analysis - rules of thumb are based largely on folklore or word of mouth.

For instance, suppose an owner hears "through the grapevine" that a competing business sold for 80% of revenues. Although the formula may be worth noting, the firm has no means of verifying the rumor's accuracy or underlying details. When you have your business valuated by a VR M&A Advisor, you will get a complete examination of what you should be selling your business for, where the buyer will know exactly what they're receiving.

They're oversimplified. Valuation formulas also fail to account for differences between industry participants, such as non-operating assets, niche markets, management quality, operating risks or geographic location. Simply stated, they don't consider many of the underlying factors, risks and attributes specific to a business that directly affect its overall value.

Moreover, ambiguous rules of thumb leave many unanswered questions. To illustrate, VR asks you to consider the prevalent rule of thumb for manufacturers of three to five times earnings:

- Does the term "earnings" refer to net income; earnings before interest, taxes, depreciation and amortization (EBITDA); or something in between?
- Does the formula assume an asset or a stock sale?
- Does it include real estate, inventory and intangibles?
- Does it generate a cash equivalent price, or did underlying transactions involve extended payouts, such as earn-outs or seller financing?

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They're outdated. As demand fluctuates, old transaction data may lose its relevance. Pricing multiples are affected by general economic conditions as well as industry forecasts and trends. For instance, an influx of new competitors, revolutionary technology or industry roll-ups might have an impact on pricing multiples.

They're not credible in court. Historically, courts have rejected rule-of-thumb value determinations if used as a stand-alone valuation method.

If you're looking to sell your business or, at the very least, determine what your company's value is worth, make an appointment to consult your VR M&A Advisor in your area. They will be able to guide you away from the incorrect assumptions of "rules of thumb," and directly to the hard, accurate numbers that a comprehensive business valuation provides.