Chapter 1: Introduction

Simply stated, business valuation rules of thumb are pricing formulas for valuing a business enterprise. Rules of thumb are often utilized to determine an approximate value range, or to provide a general base for estimating worth. While rules of thumb give a specific range of value, there are qualitative factors which will increase or decrease the value. This chapter gives an overview of the most important factors.

Applicability of Rules of Thumb

The earliest citation comes from Sir William Hope's *The Compleat Fencing-Master*, second edition, 1692, page 157: "What he doth, he doth by rule of thumb, and not by art." The term is thought to originate with wood workers who used the length of their thumbs rather than rulers for measuring things, cementing its modern use as an inaccurate, but reliable and convenient standard.

Rules of thumb are useful for establishing ranges for businesses which are worth less than $3,000,000, and are most helpful for small businesses which are less than $1,000,000 in value. In general, the smaller the business, the more applicable the rules of thumb are.

Rules of thumb are useful, assuming that all things are equal, margins are high, sales are steady, rent being paid is fair, etc. These assumptions and generalizations are:

- No impact resulting from geographic location (east versus west or urban versus suburban);
- No impact with regard to the business' debt consideration (leverage);
- No consideration of company-specific risk attributes;
- No consideration of return on investment (cash flow);
- The pricing or value of the business is based upon an average business revenue multiplier, either monthly revenue multiplier (MRM), or annual revenue multiplier (ARM);
- No consideration for the tax advantages/disadvantages of the business.

A point that warrants discussion is that sellers tend to utilize rules of thumb more than buyers do. As a result, there is often a serious disconnect between the buyer's and seller's idea of value.

Weaknesses of Rules of Thumb

A key limitation of rules of thumb is that each transaction is unique, and the rules of thumb applicable to a particular business are often incapable of quantifying the unique circumstances of a given business sale. We have provided a list of issues below that tend to have a profound effect on the pricing of a business during a business sale:

- Whether the transaction is or is not an all cash transaction.
- Debt Terms (type of loan, term, interest, etc).
- Will debt be repaid via earnouts or will the seller carry a note for the debt?
- Is the interest paid actual or imputed?
- Who will pay for the liabilities/expenses of the transaction?
- Is the transaction a stock or asset sale?
- What are the buyer and seller dynamics (personalities)?
- What is the seller's cost basis?
- How reliable are the earnings, as perceived by the buyer?

A final point to be made is that rules of thumb can change over time. For industries that undergo frequent transformation, such as the technology industries or declining industries, one must be aware of how this evolution affects the rules of thumb. For rapidly changing businesses, we suggest that other methods of valuing a business are implemented, besides rules of thumb.

Value Drivers for Businesses

This section discusses the major factors which affect the overall value of the business and the rule of thumb used.

Attrition of Customers

Customer loyalty or attrition (how rapidly a customer base stops buying from a company) can significantly impact a buyer's perception of a business' stability as an investment. In turn, customer loyalty or attrition will influence the market price for that business. This is evident when buyers inquire about the rate of repeat business for a company.