Business Appraisal Practice

Rules of Thumb: What Is Their Role in Business Valuation?

By Heather M. Burns

Summary: Rules of thumb can complement standard valuator approaches such as the asset approach, income approach, and market approach. But they are industry-specific rules, and they often generate a whole range of possible values. What’s the origin of these rules, and how can you best determine when to use them, and where in a range of numbers the most appropriate appraisal might fit? Here are some hints.

Introduction

Business valuation professionals are routinely engaged to value complex business enterprises in a diverse range of industries. The business appraiser analyzes the subject entity’s past performance, calculates the current worth of its tangible and intangible assets, estimates its earnings capacity and compares it to sales of similar businesses in order determine the entity’s value at a specific point in time. In addition to the standard valuation techniques (asset approach, income approach and market approach), industry-specific rules of thumb are often analyzed and, sometimes, incorporated into the appraisal report.

Rules of Thumb

Rules of thumb are industry-specific pricing guidelines detailed in various professional journals and books. These publications also provide general information, pricing tips and resources by industry. Rules of thumb exist for many, although not all, types of businesses, and they vary by industry from multiples of sales or EBITDA (earnings before interest, taxes, depreciation and amortization) plus asset categories (such as shuttle service businesses estimated at 3 times
EBITDA plus the value of the vehicles), to industry specific metrics (such as telecommunications businesses estimated at $700 to $1,400 per line). For purposes of illustration, we use a beer distribution business as an example of specific pricing guidelines in an industry. Further, we discuss the industry dynamics, traits specific to the subject business and application of the rules of thumb established for the industry.

**Industry Dynamics**

The business appraiser first thoroughly researches the subject industry in order to understand the environment in which the subject business operates. In our example, the subject business is a beer distributor operating within the United States. Beer distributors in the U.S. operate in a unique regulatory environment established by state and federal governments as a result of the 21st Amendment to the Constitution. Since the end of prohibition over 75 years ago, malt beverages in the U.S. have been distributed according to a three tier system consisting of: licensed suppliers (brewers and importers), wholesale beer distributors, and retail establishments. The distributor acts as an intermediary between breweries and importers on one side and bars, restaurants and liquor stores on the other. The distributor provides warehousing and delivery enabling brewers and retailers to keep inventory and storage costs low, it has a territory monopoly for the brands it distributes and, by law, it cannot be bypassed by the brewers or importers going directly to the retailer. Additionally, the distributor takes on retailer nonpayment risk, is responsible for product freshness and facilitates the recording and collection of state and local taxes. The mature U.S. beer industry is characterized by industry consolidation and a unique system of competition where distributors obtain exclusive rights to distribute specific brands of beer within a defined territory.
The Three Tier System:

![Diagram of three tiers: Brewers & Importers, Wholesale Beer Distributors, Retailers (Bars, Restaurants, Liquor Stores)]

**Traits Specific to the Subject Business**

Once the appraiser understands the industry in which the subject business operates, the focus shifts to how the specific business operates and what traits make it different from the typical business in the industry. In order to analyze the subject business, the appraiser interviews management, tours the business facility and reviews the subject’s historical balance sheets and income statements. A financial statement analysis helps the appraiser to identify positive or negative trends within the business enterprise over time and to see how the subject compares to other businesses in its industry. Often, a comparison between the subject business and its peer group is completed through the use of company data compiled by organizations like the Risk Management Association (RMA). These published studies group companies within an industry by annual sales volume in order to provide benchmarks on industry balance sheets, income statements and financial ratios. To use this data effectively, the appraiser figures out how the subject relates to the peer group norm, where it differs from the peer group and why it differs. The results should indicate whether the subject business is positioned better or worse than a typical business in the industry market place. A beer distributor may differ from its peer group norm in any number of ways such as having: a larger percentage of fixed assets (well maintained vehicles and equipment enabling it to provide exemplary service to retail driving routes); larger intangible assets (due to the acquisition of valuable distribution rights); higher profitability as a result of holding more popular brand rights in condensed urban areas or, conversely, lower
profitability due to having a wide rural distribution territory or as a result of holding the rights to less popular brands.

**Applying Rules of Thumb to the Subject Business**

After the business appraiser has analyzed the overall industry and the traits specific to the subject business, it is a good idea to review the rules of thumb for businesses in the subject’s industry. In practice, we generally use industry specific guidelines as an overall check for reasonableness. However, now and then, we incorporate a rule of thumb into our guideline method of the market approach to further support our analysis, especially when the rule of thumb is well established in the industry and is used by prospective buyers. According to the 2009 Business Reference Guide, the price of a beer distributor is affected primarily by the brands carried and the distribution territory held. Two guidelines for estimating the value of a beer distribution business are summarized below:

<table>
<thead>
<tr>
<th>Rule of Thumb 1:</th>
<th>Rule of Thumb 2:</th>
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<tbody>
<tr>
<td>$5 to $15 x number of cases sold over the last 12 months</td>
<td>Inventory at cost</td>
</tr>
<tr>
<td>+ hard assets</td>
<td>+ rolling stock</td>
</tr>
<tr>
<td>+ inventory</td>
<td>+ any land &amp; improvements included in sale</td>
</tr>
<tr>
<td><em>(multiple per case depends on popularity of brands sold)</em></td>
<td>+ $1 x number of cases delivered per year</td>
</tr>
<tr>
<td></td>
<td>+ $1.5 x number of kegs delivered per year</td>
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Rules of thumb generally produce a range of value estimates depending upon the characteristics of a given business. Because each business is unique, the appraiser must judge whether the industry guidelines are applicable or not. In the following example we applied the previously described rules of thumb to calculate a value range for a hypothetical beer distributor. In this case we have narrowed the $5 to $15 range from Rule of Thumb 1 to $4 to $6 as this is more typical of the level we have seen in the marketplace.
In this example, the range of value estimates for the hypothetical beer distributor runs from a low of $2.1M to a high of $7.1M based on the per-case multiple used, with a much more narrow range of $5.1M to $7.1M using Rule of Thumb 1. As brand popularity is a driving factor in the case equivalent component to the value estimate, the value range for the hypothetical beer distributor (holding rights to brands with average popularity) can be narrowed toward the average value. It is also important to note that these rules of thumb are not sensitive to qualitative factors such as a level of distribution rights held that is higher or lower than the typical level or a distribution territory that is superior due to its condensed urban nature or inferior due to its wide rural nature. Since qualitative factors frequently have a material impact on value, the appraiser must make reasonable value adjustments to account for all relevant factors. Our example reinforces the principle that there is more to valuing a business than simply plugging data into a general formula and selecting the dollar amount generated. Valuation professionals rely on a variety of methods, weighting each method based on its relevance to the given business enterprise, in order to arrive at a reasonable value.

**Conclusion**

Rules of thumb are useful in the appraisal process as they provide a standard range of value within specific industries. Even if the subject business has unique aspects which set it apart from the peer group, it is important for an appraiser to be aware of the rules of thumb for similar businesses. If the appraiser understands and explains why the subject business does or does not fit within the standard range, the analysis is more likely to result in a defensible value.
conclusion. Rules of thumb are not a substitute for analyzing the subject business using the asset approach, income approach and market approach to value. They do, however, provide an overall check for the reasonableness of the value conclusion and may be used to further support the appraisal analysis.

Heather Burns is a business appraiser with Shenehon and Company based in Minneapolis, Minnesota. Heather joined the business valuation team in early 2007. Her experience to date includes 100% and partial interest valuations for estate and gifting purposes, potential sales and marital dissolutions. Heather is a member of the Institute of Business Appraisers and is actively pursuing her CBA designation.