

What's Your Business Worth - Beware of Rules of Thumb

There are many reasons you may need to know the value of your business, such as pricing it for sale, seeking financing, tax and estate planning, or even divorce. Many business owners use rules of thumb to gauge their businesses' values. But while these “cocktail napkin” estimates can be a good way to get a general idea of what your business is worth and begin the planning process, they're no substitute for a thorough analysis by a valuation professional.

The Trouble With Rules of Thumb

Rules of thumb are easy-to-calculate valuation formulas, typically tied to some multiple of earnings before interest, taxes, depreciation and amortization (EBITDA) or some other measure of earnings, revenues or cash flows. Often they're derived from data about actual business sales in your industry, which gives them an air of legitimacy.

The problem is that rules of thumb are usually based on industry averages. But most businesses don't possess characteristics that are identical to the hypothetical “average” business, so applying a rule of thumb may lead to inaccurate results. Consider this example:

Company A and Company B each have EBITDA of \$2 million per year. According to a popular valuation rule of thumb in their industry, each company is worth five times EBITDA, or \$10 million. The two companies are similar in many ways, but a closer look reveals that Company A relies on a single customer for more than 80 percent of its sales. Company B has a much more diverse customer base, with no single customer accounting for more than 10 percent of its sales. Any prospective buyer that does its due diligence would view Company A as a substantially riskier investment and adjust its valuation downward to reflect the additional risk.

Professional Valuation: There is No Substitute

The example above is a bit oversimplified, but it illustrates how rote application of rules of thumb can distort a business's value. In practice, each business possesses numerous characteristics that drive its value and may or may not be captured by a rule of thumb. Rules of thumb provide a handy way to get a rough estimate of your business's value or to serve as a “sanity check” against more sophisticated valuation methods. But only a professional valuation can provide the accurate information you need to achieve your goals.

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