

# SBA VALUE



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## Risky Business: Relying on Valuation Rules of Thumb

They can be useful to determine if a proposed business transaction seems reasonable prior to accepting an SBA loan application. However, most businesses are unique, and applying a rule of thumb without additional analysis can be dangerous.



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# Risky Business:

## Relying on Valuation Rules of Thumb

by **Neal Patel, CBA**

Using a rule of thumb approach is a simplified form of the market approach, in which a “ballpark” multiple is applied to either the earnings or revenues of a business to obtain the estimated value of the business. Sometimes the rules rely on multiples of operational data such as number of hospital beds or customers, or a combination: X times revenues plus value of vehicles. These multiples are considered to be “pricing tips” by business brokers, and can be found in various publications and journals. For example, average liquor stores sell for 40-50% of annual revenues, or typical dental practices sell for 2.5 times the seller's discretionary cash flow. SBA lenders should know that rules of thumb are not considered valid appraisal methods in the appraisal industry, and are only used to validate the reasonableness of values generated by the market, income, and asset approaches. They can be used by SBA lenders to determine if a proposed business transaction seems reasonable prior to accepting a loan application. However, there are many other key factors that come into play that will skew multiples up or down. Some of these include gross profitability, lease terms, location, number of employees, and net profitability.

### Why Use Them?

Rules of thumb are quite commonly used by business brokers to help a seller estimate a price of a business for sale. As mentioned, the most typical rules of thumb are based on a multiple of sales or earnings that other similar businesses have sold for. For example, an accounting firm generating \$200,000 in revenues that should sell at 1.25 times (125% of) annual sales would have an asking price of \$250,000. Another multiple is based on income streams: namely EBITDA or Seller's Discretionary Earnings (SDE) (EBITDA + owner's compensation + discretionary expenses). The same accounting firm with SDE of \$100,000 would sell for 2-3 times SDE, or \$200,000 to \$300,000. What significance does the 2-3 times SDE mean? It's essentially the period of time it will take for a buyer to get his/her investment back, assuming an all cash purchase. It's equivalent to a return on investment of 50% to 33%, or a 2 to 3 year return on initial investment.

### The Risk Factor

The rule of thumb averages may be accurate indicators for businesses that have similar performance and profitability to the industry averages (as frequently measured by SBA lenders with a comparison to the RMA studies). A business with expenses and profits that are similar to RMA industry averages may sell for a price in line with the rule of thumb formula. However, most businesses are unique, and applying a rule of thumb to a business that varies significantly from the industry average is not appropriate. In the previous accounting firm example, what happens if most of the clients have known the seller/CPA for 20 years, and they plan to change accountants if he leaves the practice? Or if a majority of the clients are one time personal tax return clients, compared to a firm that has recurring business clients? Do the rules of thumb still apply? What if the seller/CPA only works 1 day a week? I know a few CPA's that would pay a premium for that type of schedule!

In *The Lawyer's Business Valuation Handbook*, Shannon Pratt, a well-known authority in the field of business valuation, compared rules of thumb multiples for 13 popular industries to actual multiple ranges derived from two major business valuation databases: the BIZCOMPs database and the Pratt's Stats database. The result showed that the actual multiples diverged quite a bit from the rules of thumb, proving that rules of thumb are not very reliable. An example was the restaurant valuation rule of thumb of 30% of sales, compared to the value of actual transactions ranging from 18% to 112% of sales!

Nearly every professional valuation association does not allow for a rule of thumb to be used as the primary valuation methodology. The new Institute of Business Appraisers (IBA) Professional Standards, which are in parity with the AICPA's Statement on Standards for Valuation Services, specifically state, “Rules of thumb are acceptable as reasonableness checks, but should not be used as [a] stand-alone method”. Accordingly, relying on rules of thumb alone to value a business may result in a value that will not be defensible before the IRS or in courtrooms.

Continued...

### Two Recent SBA Transactions

Often, clients will ask us for a reasonableness opinion of a purchase price prior to accepting a loan application for an unfamiliar industry. A recent example was a client enquiring about a chiropractor practice which seemed to be overpriced. The asking price was \$400,000, annual revenues were \$300,000 and the Seller's Discretionary Earnings were \$150,000 (approximations). That pricing was based on a 1.3 times annual sales multiplier, and a 2.6 times SDE multiplier. Rules of thumb for this type of business indicate 0.6 times annual sales, or 2 times SDE. Accordingly, it seemed that the purchase price was set above the rules of thumb values. After a conversation with the borrower, it turned out that the practice had opened 3 years ago, with annual revenues in the first three years of \$75,000, \$175,000 and \$300,000, respectively. This type of historical growth rate may continue for a few more years, in which case the purchase price may in fact be reasonable. However, in this instance the rules of thumb multiples were not an accurate measure of reasonableness.

Earnings are generally a better measure of a business' value than revenues, as revenues do not take into consideration important factors such as gross profitability, leases expenses, etc. Recently a lender called regarding a manufacturing company that was being sold at 1.5 times its annual sales. The rule of thumb for this industry is 40%-50% of annual sales, so the client was concerned about the valuation. However, the company manufactured a niche product that sold at a very high profit margin, which created higher than average EBITDA. Accordingly, the earnings multiple was 4 times EBITDA, which is well over the industry rule of thumb of 2.5-3 times EBITDA, and justified the purchase price at first glance. Therefore, the rule of thumb caused unnecessary confusion rather than providing assistance to the client.

### Where Do I Find Them?

After reading a page and a half about why rules of thumb are risky, are you still wondering where you can find them? Rules of thumb are not hard-and-fast rules found from one source. The best place to find them is by speaking to local business

brokers that you may already work with. Locality is one major reason why rules of thumb may be unreliable, as a liquor store in New Jersey is probably worth more than one in Florida due to the limited availability of new licenses in New Jersey. Accordingly, a local business broker in New Jersey will probably have a rule of thumb that is more reliable than a national book or journal. The next best place to find a rule of thumb is by calling a certified business appraiser. Experienced appraisers value hundreds of businesses that vary by industry, and they should be able to give you rules of thumb for most industries that they are familiar with. Lastly, there are many rules of thumb formula books and reference guides available on the Internet. These may provide an overall guidance, but remember geographic location may have a major effect on the rule of thumb, so be careful.

### Conclusion

It is important for lenders to remember that rules of thumb do not consider the specific characteristics of a company that may create additional value when compared to the industry or similar companies. Additionally, rules of thumb do not generally reflect changes in the economy or subject industry over time. Certified appraisers that are familiar with the SBA related business valuations should only rely on rules of thumb as a sanity check when testing their conclusion of value to see if the final multiples are within the typical range – if not, a brief explanation as to why the subject company differs from industry norms may be warranted.

## ABOUT RELIANT

**Reliant Business Valuation is a leading nationwide provider of certified third party business valuations for SBA lenders.** All reports comply with SBA SOP 50-10 5(C) and USPAP requirements. Call Neal Patel (Certified Business Appraiser) at any time to discuss a valuation request.

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