

## What Is Wrong With Rules Of Thumb?

All owners have a number in their heads representing what they think their businesses are worth, but as we've seen that number is wrong – usually by at least 50%. Where did this wrong number come from?

Usually it comes from a “rule of thumb”. Every industry has its own rule of thumb. Let's examine rules-of-thumb and you will understand why owners should never rely on them.

Let's take as an example two dry cleaners in the same town with the same annual sales of \$1 million. It so happens the rule of thumb for the dry cleaning industry is a shop is worth one times its annual sales, so according to the rule of thumb since both shops do \$1 million in sales, each is worth \$1 million.

In fact a professional appraiser can look at these two shops and conclude one is worth twice the other. How is this possible? How can two businesses in the same industry in the same town doing the same sales have different values? It turns out it is easy.

Dry Cleaner #1 is a brand new store located in an upscale part of town. Last year it did \$500,000 in sales, this year \$1,000,000, and next year it expects to do \$1.5 million. Its equipment is spanking new. It has good aggressive management. Everything about this business is trending upwards.

Dry Cleaner #2 is located in a ghetto. A few years ago it was doing \$2 million in sales, now it is down to \$1 million. The roof leaks. The property, plant and equipment is old and needs repairs. Basically everything about this business is trending downwards.

Two businesses, same industry, same sales – completely different values. But a rule of thumb never picks up on that. That is why owners should never base the value of their businesses on a rule of thumb.