The Business Issue

BUSINESS

Valuing Businesses: Beware of Rules-of-Thumb

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Rules-of-thumb to value businesses and professional practices, especially the Main Street variety, are commonly used to gauge the range of potential value a business has. They are cost-efficient to apply (certainly!), and sometimes rules-of-thumb reflect buyers' expectations and the word-on-the-street regarding the value of a particular type of business. To use them, one simply multiplies a financial fundamental of the business, for example, annual revenue, by a market multiple expressed as a ratio: annual revenue times 0.5 equals business value.

But their downside severely outweighs their benefits.

First, rules-of-thumb may be outdated. As market multiples change over time or during an economic cycle, rules-of-thumb often do not keep up. So, they may not be timely or provide current market value.

Further, rules-of-thumb frequently reflect large ranges of value. If you apply the high end of the rule-of-thumb range, the resultant value may suggest you can cash out your business and retire early. In contrast, if your business would sell at the low end of the ratio range, you may need to plan for several more years of work in the business.

Lastly, which business assets and liabilities are included in the rule-of-thumb value vary by industry and even within an industry. What the resultant value represents may not be clear at all.

How do you overcome these serious disadvantages? Well, there is no easy way. Rigorous fundamental analysis of the financial statements of the business must be performed. One must determine how competitively your business compares to current industry benchmarks. Does your industry's trend anticipate poorer or improving prospects? Value is in the future, not the past. Have the key internal systems of your business improved or fallen behind over time? There are dozens of questions that need to be answered. How old are your greenhouses and equipment? How efficient are they? What is your labor turnover? What are your managers' tenure? Has your operation lost the ability to ship to a critical market? Do officer compensation and family-owned land rent exaggerate economic profit or depress it? Have you gained or just lost large sales accounts?

As it goes for so many things in life, there is no simple way to arrive at a realistic value for your business. Why is a proper appraisal so important? When you put your business up for sale, you do not want to leave money on-the-table or dismiss what was really your best opportunity to sell. Both are bad outcomes.

Consult a business appraiser who has the necessary skills and experience to narrow that rule-of-thumb range to a value you can rely on. Nearly every major urban area has credentialed and experienced valuation experts who are compensated by fee to ensure objectivity and independence.

About the Author:

John A. Cento, CPA/ABV, ASA is a certified public accountant based in New Albany, Indiana and INLA member. He is a specialist in business valuation accredited by the American Institute of Certified Public Accountants and the American Society of Appraisers.

John's love of plants and horticulture began as a boy in Beech Grove watering his family's newly installed trees for a quarter a piece. In adult life, that passion developed into amateur botany, leading wildflower field trips for his local native plant society. Currently a Master Gardener and an INLA Accredited Horticulturist, he appraises horticultural operations as well as a myriad of other industries.

With over 25 years of professional experience, John contributes his insights and expertise on financial matters. For further study, you can visit his firm's website at www.indianaba.com or www.greenindustryvaluations.com.