The industry rule of thumb approach to valuation

In past newsletters we have touched on various aspects of business valuation. In this edition we look consider what is meant by an industry "rule of thumb" valuation approach.

Remember that the true value of a business is what someone will pay for it. In order to arrive at this figure, buyers use various valuation methods. The main valuation methods being based on:

- Assets - this method may be appropriate if a business has significant tangible assets, or perhaps is not trading profitably.
- Price/earnings ratio - this method is appropriate if a business is making solid profits.
- Entry cost - this method values a business based on how much it would cost start it up from scratch.
- Discounted cashflow - this calculation is based on an estimate of future cashflows. It is appropriate for businesses which have invested heavily and are forecasting steady cashflow over many years.
- Industry rules of thumb - this method uses an established, standard formula for a particular sector.

When valuing a business, you usually use at least two of these methods to arrive at a range of values.

What do we mean by the industry rule of thumb approach?

One definition for "rule of thumb" is:

> *"a broadly accurate guide or principle, based on practice rather than theory"*

In some industry sectors, buying and selling businesses is common. This leads to the development of industry-wide rules of thumb. The rules of thumb are often dependent on factors other than profit. For example:

- Turnover;
- Number of customers or residents (for example, at a hotel or care home);
- Number of outlets;
- Amount of funds under management.

Buyers will work out what the business is **worth to them**. For instance, a business with a large client list but no profits could be valuable to a larger competitor because the two businesses could be merged.

Broadly speaking perhaps the most widely applied rule of thumb relates to turnover. We have come across various sources quoting rules of thumb applying for some industries/sectors as follows:

Accountancy firms	80% – 125% of turnover
Investment firms	8% - 10% of assets under management
Law firms	40% - 100% of annual fees
Off-licences	5% of turnover + stock
Opticians	30% - 75% of gross receipts
Public houses	50% - 60% annual sales

Limits to the application of the industry rule of thumb approach

The underlying premise to a 'rule of thumb' approach is the belief that profitability in the sector does not vary significantly, and that each company operating in the sector will have similar characteristics. However, one should not lose sight of the fact that when considering turnover this is only one factor that feeds into driving future available cash to a prospective buyer. Perhaps this is best illustrated by a short example. Included below are the key metrics from the profit and loss accounts of two notional businesses, B1 and B2 where a rule of thumb based on turnover is generally applied:

	B1	B2
	£	£
Turnover	1,000,000	1,000,000
Cost of sales	(710,000)	(800,000)
Gross profit	290,000	200,000
Rent	(36,000)	(24,000)
Other costs	(100,500)	(100,500)
	153,500	75,500

Clearly both B1 and B2 have the same level of turnover, however, B1 appears to be more profitable than B2. Straightaway then you can see that if you were to adopt an approach of valuation derived from turnover you **might be** getting a better deal were you to buy B1 instead of B2 as it would generate more cash for you. It is not uncommon for businesses in the same sector to have different levels of profitability based on similar levels of turnover and this can be for any number of reasons, such as:

- Assuming staff costs are included in cost of sales, then you would expect higher staff costs (and hence lower gross profits) if one business remains open longer than another – opening times can vary significantly in retail businesses. Hence, whilst turnover might be the same, it may be that it takes one business more time to generate those sales than another;
- Staff costs may also be higher depending on where a business is located – e.g. central London v central Hull;
- Sales prices may also vary depending on the specific nature of the business and where it is located – e.g. convenience stores charge more for their stock than large supermarkets;
- You may also have different business lines with different margins, for example typically pharmacies derive revenue from prescriptions, counter sales and sometimes wholesale sales, all of which have different margins. It might be that B1 and B2 are opticians businesses and perhaps B1 sells more designer frames than B2 which is more dependent on NHS prescription frames etc.

In addition to differing margins, businesses in the same sector may well have different overhead costs that will affect underlying profit. In the above example, whilst B1 appeared more profitable overall and at the gross profit level, it appears to have higher rent costs than B2. This might be because it is in a more attractive location for the business, such as an affluent high street in the case of an optician's business rather than say in a parade of shops in a less affluent neighbourhood. In this case, the better location may have contributed to the higher profitability of B1. On the other hand, it may simply be that the owners of B1 were not able to negotiate as good rental terms as the owners of B2. If so, this might be of a concern to a potential buyer; whilst a buyer might be able to impose some of its own cost structures (and savings) on an acquired business, it may not be able to divest of an onerous lease for some time.

Conclusion

The above points are aimed at demonstrating that a rule of thumb approach, here assuming a multiple of turnover, might be helpful to establish a ball park value but it is not sufficient in itself for assessing the actual value of a particular business and that the underlying specifics of each business need to be considered in context.

We suggested in the worked example that B1 might be worth more than B2 given their apparent relative levels of profitability – what if, though, B1 only had 12 months left on its lease and B2 had a further 14 years….