

WHAT'S IT WORTH?

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For Business Owners, Corporate Officers, & Their Advisors

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There's No Foolproof Formula for Value The Pros and Cons of Rules of Thumb

Submitted by Travis Haynes

Rules of thumb have been used to value businesses for years. Business brokers and small business owners rely on them to get a ballpark sense of a company's value while bypassing more complicated financial analyses.

Typically, a client or attorney asks, "What is the rule of thumb that would apply to a business like this?" The appropriate answer is that rules of thumb are just a starting point and are intended to provide only a ballpark value estimate. Unfortunately, many rules of thumb have found their way into the valuation profession; inexperienced valuation consultants use them, primarily because they are simple and easy to understand.

The unfortunate result is that rules of thumb turn out to be wrong more often than they are right. Why? Here is a closer look at the pros and cons of these formulas.

Real-Life Story

Take the case of Tom the accountant. A common rule of thumb is that an accounting practice is worth between 40% and 150% of the firm's annual billable revenues. XYZ Firm offered Tom a one-third partnership share in the firm based on a similar formula. It was an intriguing offer. XYZ had a highly regarded reputation and a good client base, and its billable revenues had grown nicely over the last few years. But on examining XYZ's financial statements, Tom found that a few years earlier the

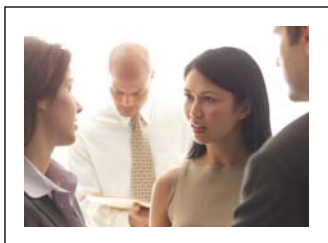
partnership had accepted a project involving a large, as yet unpaid, fee.

Unfortunately, XYZ never collected its fee. As a result, it was forced to borrow from its bank to pay staff salaries and cover its overhead. The bank loan's interest had consumed most of XYZ's profits in the past two years and would continue to drain away hefty profits for the next few years. The rule of thumb suggested that a one-third interest in the firm was worth \$200,000. So the question for Tom came down to, "Would you invest \$200,000 for a partnership interest with good revenues but no cash flow?"

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Self-Fulfilling Prophecies?

Experienced valuers, investment bankers and advisors know that rules of thumb cannot be ignored — they tend to become self-fulfilling prophecies if the formula is widely disseminated. In fact, the American Institute of Certified Public Accountants cautions against the exclusive use of rules of thumb, but then goes on to state: "The [valuation expert] should not ignore what is being done in the industry. Frequently, an industry rule of thumb provides a representation of the perception that people have in the marketplace and should be one of the methods used in valuing the closely held business."



Often, buyers and sellers, regardless of their sophistication, begin to accept these rules of thumb without question if they hear them often enough. As a result, many companies and private practices are actually sold based on these formulas. How should a valuator approach this issue when valuing a business?

He or she should first apply traditional valuation methods to arrive at a value for the subject business. Next, the valuator needs to identify the appropriate rules of thumb to demonstrate his or her awareness of these rules and their industry currency. If the rule of thumb is acceptable on its face, the valuator should apply it to the subject company. But if it is faulty, he or she should discuss its weaknesses and not apply it to the analysis.

If the indicated value is close to the value arrived at through the application of more traditional valuation methods, then a valuator may present it with no further comment.

But if the indicated value is not similar, the valuator needs to explain why the rule of thumb is or is not appropriate in this specific situation.

The Bottom Line

The bottom line is that rules of thumb have their place in a valuation analysis, but they do not and should not replace thorough financial analysis and traditional valuation methods. We can provide more information on rules of thumb if contacted by phone or e-mail.



Do you own a business or advise a business owner? Contact Dave Moser to arrange a free valuation consultation.

Sidebar: 4 Rules of Thumb Categories

Rules of thumb typically fall into four categories:

1. A multiple of some operational unit (such as restaurant tables, hospital beds or newspaper subscribers),
2. A multiple of book value or asset value,
3. A multiple of earnings, such as net income; owner's discretionary cash flow; earnings before interest, taxes, depreciation and amortization (EBITDA), or
4. A multiple of gross revenues.

These general categories contain a multitude of exceptions and can offer only a rough estimate of value.

Service Update: Cost Segregation

The Valuation & Transaction Services Group recently completed a component cost segregation study for a client in the restaurant services industry. Results of the study allowed the client to increase cash flow from taxes by over \$300,000 in the next five years. If you own real estate with a value of over \$1,000,000, please contact us to further discuss cost segregation.

"The bottom line is that rules of thumb...should not replace thorough financial analysis and traditional valuation methods"

Meet the Valuation and Transaction Services Group

By: Dave Moser, Director Valuation & Transaction Services

I hope you have enjoyed our complimentary newsletter. **If you would like to add a client or friend to the distribution list, or join our monthly e-mail newsletter, please e-mail: dmoser@coulterjustus.com** with "Subscribe" as the subject.

Our Valuation and Transaction Services team has over 60 years of combined experience involving more than 1,000 projects, and continues to be the largest and most experienced full time valuation group in East Tennessee. We understand the significant financial and emotional impact our services play in client's lives, and are excited to offer a full range of transactions services.

In addition to business valuations throughout North America and Internationally, we provide M&A advisory services for substantial private firms, as well as a host of real estate advisory services including: cost segregation studies, real property tax appeals, lease audit and negotiation, and feasibility analysis.

David G. Moser, ASA, CEI

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David is a certified member of the American Society of Appraisers (ASA) and has over 34 years experience in the valuation profession. Before joining Coulter & Justus in 1996, he served as partner and director in charge of valuation with Ernst and Young and in management positions with two other international valuation firms. He has considerable experience in valuations, cost segregation studies, and as an expert witness.

Renee M. Harwell, CPA/ABV, ASA

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Renee has been valuing businesses full time for the past twelve years. She has valued businesses for purposes including estate, gifting, mergers and acquisitions, buy-sell agreements, purchase price allocations, bankruptcy, reorganization, and litigation. Renee joined Coulter & Justus, PC in 1999, is an Accredited Senior Appraiser of the American Society of Appraisers, a CPA, and is accredited in business valuation by the AICPA.

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Having closed several hundred thousand feet of real estate deals, Chris specializes in commercial real estate consulting, appealing real property tax assessments, and business valuation. Chris holds an MBA from the University of Notre Dame Mendoza School of Business, as well as the CCIM (Certified Commercial Investment Member) designation, and AVA (Accredited Valuation Analyst) designation.

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Sven has over 14 years experience in investment banking and business valuation, including mergers and acquisitions. He joined Coulter & Justus in 2003 and has an MBA with an emphasis in Finance from New York University's Stern School of Business and also holds the CM&AA (Certified Merger & Acquisition Advisor) designation.

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Cindy has over 14 years client service experience in the areas of auditing, budgeting, and finance as well as general business consulting. She joined Coulter & Justus in 1997 as a Business Valuation Consultant.

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Travis has an MBA with a concentration in Finance from the University of Tennessee. Before joining Coulter & Justus in 2008, Travis completed the Retail Leadership Program with Regions Bank, and worked as an Associate Business Banker focused on developing and managing a residential construction loan portfolio.

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