The Digital Approach (with a nod to Jackie Mason)

There are three methods of valuation – cost, income and market. However, there is kind of a fourth method, which we refer to in the title as the digital or finger approach – more commonly referred to as the Rule of Thumb (ROT). The ROT approach tends to be a derivative of, but often the bastard child of, the market approach, and sometimes mixes in elements of the income approach. As a general comment, a ROT is questionable way to do a valuation, and only rarely should it be allowed to stand on its own. Any kind of ROT approach, any kind of use of a ROT, must be done very cautiously. It would be unusual for a ROT to be used as the exclusive measure of value, and not much better if it were to be used as the main approach to value. While there are exceptions, a ROT is more appropriate as a kind of rough sanity test, as little more than a sense of what one (or sometimes several) stream of thought believes the so-called average company in that field is worth.

Note a very important word in the previous sentence – average. A ROT typically gives some form of a multiple (for instance one time sales, five times net income, $10 for every hour of service, etc.) to measure value, and sometimes also gives a range rather than a specific multiple – i.e. between 4 and 6 times net. Assuming that these ROT are more than one person's guestimate of what the market will bear, ROT has been developed typically based on historical situations involving actual transactions. The number, or the range, is for determining a normal or average situation. It is questionable whether you would really know, as to the subject company being valued, and the various financial metrics, if that company is about average, considerably better or considerably worse. To know that, you would have to know what is average for the industry – and usually that information is not available. ROT provides no better than a rough sense of what a so-called average company might be worth.

When a substantial volume of transactions exist, it is possible that what might otherwise have been simply a ROT becomes more meaningful, in the form of a transactional database. By way of illustration, there is a crude ROT for accounting practices (subject to many weaknesses) that they are worth between 75% and 150% of (between ¾ and 1 ½ times) annual gross revenues. The merit of this approach is that there have been a sufficient volume of transactions, of accounting firms actually changing hands, that ROT databases have been developed, and a reasonable range of the average sales transaction established. In that sense, what was perhaps a ROT has evolved into something more reliable. Even then it is still a range, and in this case that range for say a $1 million grossing accounting practice would put the value between $750,000 and $1.5 million – a rather substantial spread. Further, you still need to know where in the continuum of superior to average to inferior the subject firm is positioned. Thus, even where a ROT has evolved (because of the volume of transactions) to a somewhat reliable type market approach, many questions remain. We most strongly caution our readers to look askance where a ROT forms the foundation for valuation, and to take a most jaundiced eye to a valuation calculation that relies to any significant degree on a ROT. While possible, proceed with caution.

The following is a real life example of the dangers of a ROT, and how we succeeded in countering a report which relied upon a ROT. We were involved in a valuation involving a pool service business located in New Jersey. The other expert relied very heavily on a ROT, derived from a well-known source/book which provides these types of benchmarks. There was no question but that the subject business fit into the category being used, and there was no question but that the other expert read/interpreted, and applied, the ROT correctly – within the limits of what a ROT allows. Thus, anyone looking at the same numbers, and using a ROT, would come up with the same conclusion. Of course, that is only valid if in fact the ROT is valid. We were asked to review that expert's report and see if it had any weaknesses.

We were able to satisfy ourselves that, as far as it could be relied upon, the other expert correctly applied the ROT from the source material. However, the determination of value struck us as illogical under the circumstances. We contacted the publisher of the text in which the subject ROT (along with many other ROTs) was printed. We asked the publisher to put us in touch with or provide us with the names of the various sources (usually these are business brokers) who supplied the information that enabled the publisher to consider that to be a useful ROT for that type of business (pool service). The publisher was most cooperative – and two critical items became immediately apparent. First, it was not several sources that provided this ROT – it was just one. Thus, the so-called ROT had only one allegedly authoritative source. That potentially is a serious shortcoming – just how authoritative, how involved in that field, is this one source, how many transactions constituted the base for making that ROT.

The second critical aspect revealed to us through the publisher was that this one source happened to be located in Arizona. This is far more than merely a geographical issue – Arizona has year-round outdoor swimming. Most of us would instinctively recognize that New Jersey (even if we were to go to south New Jersey), other than for a few hardy souls, does not lend itself to year-round outdoor swimming. Our season is more like three months. Therefore, the use of a ROT, even if it were a valid one with multiple sources, when that ROT relies upon a climate that provides for year-round swimming as contrasted with New Jersey's, clearly cannot be considered relevant to a New Jersey business. Thus, the ROT used was… ROT-ten.

A ROT tries to use a "one-size fits all" approach toward business valuation. It cannot – there are many variances from one business to another, and indeed every business is different. While there may be a merit to looking at a ROT, and perhaps benchmarking against the specific company at hand, it would truly be an unusual situation where a ROT could properly be used for more than a crude sense of whether the value conclusion derived from other more reliable type sources and approaches is consistent with what appears to be a rough sense of value for that type of business. Even then, as indicated, there are issues as to how the subject entity compares to the so-called average (which you will almost never really know), how many sources make up the ROT, how reliable are those sources, and are there significant shortcomings in comparing the ROT to the subject company (i.e. geography).