

The Rule of 10: Size Comparability and the Market Approach □

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Revenue Ruling 59-60, the foundation of business valuation, requires in Section 3, Paragraph 1 that appraisers exercise “common sense, informed judgment and reasonableness” (what Chris Mercer aptly calls “The Big Three”) in developing and defending their opinions. It is always preferable to be able to marshal more than that – market data, case facts and circumstances, logic, and valuation theory – but sometimes we simply do not have any of those available.

This article presents our *opinion* concerning one such matter where all we have to rely upon are The Big Three – the size criterion screen to use when selecting comparable guideline (public or private) transactions or companies. We italicize the word “opinion” because it is based only on The Big Three. Unfortunately, we are not aware of any published evidence or authoritative literature on the topic, except for a discussion by Gary Trugman in the second edition of his *Practical Business Valuation* (page 173) and a quote by Ray Miles, IBA Founder:

“A number of studies have indicated that the size of a business has some effect on the price for which it will sell. However, the relationship between size and price has not yet been well defined. Until it is, a good precaution is to limit businesses used for comparison to those whose size is within a factor of ten of the subject business.” (Mr. Miles comment was intended to provide guidance when selecting guideline transactions from the IBA transaction database).

“When evaluating the value obtained by the Guideline Public Company Method (GPCM), courts will carefully examine whether the selected guideline companies and the subject are truly comparable. In many instances, they have not considered the GPCM because the appraiser did not show that the subject company and the guideline company were sufficiently similar. The main reason Courts have rejected the use of the GPCM is that the companies were too dissimilar in size. They have also rejected the use of the method due to differences in customer concentration; product mix; geographic diversification; and lack of statistical correlation between the public companies and the subject company’s price-to earnings ratio. The courts have said that, if the companies are not very similar to the subject, the sample of guideline companies should be larger to make up for the dissimilarities.

Our opinion is that potential guidelines that have less than 1/10th or greater than 10 times the revenue of the subject company should not be considered comparable in the absence of compelling evidence to the contrary.

We take no credit for conceiving this criterion, which we call “The Rule of 10.” We learned of it through discussions with colleagues, courses we took, and peer reviews. It is, arguably, accepted in the valuation community. The sole purpose of this article is to suggest using the “Rule of 10”, because we have found it to be useful and consistent with The Big Three. This is because potential guidelines that fall outside of its range have different characteristics, including but not limited to:

Business, product, distribution, and geographic diversification
Depth and quality of management and organizational structure
Market share and pricing power

Cost and margin structure

Research, development and innovation capacity

Access to and cost of debt and equity capital

Attractiveness to different types of buyers / investors

Quality of reported financial information

For public companies, breadth and depth of securities analyst coverage

In summary, these imply sufficiently different risk and return characteristics to void the comparability of guidelines falling outside of the Rule of 10 size range.

The Rule of 10 is not absolute, however. There may be situations where companies outside the range are close fits, although we would expect that those would be rare. More often, a potential guideline company or transaction will be well within the 10-times or 1/10th size range, but a close examination its operations will eliminate comparability, even for businesses with the same Standard Industrial Classification. Changes in product mix or the elimination of production with outsourced product can completely change the dynamics of a business. In a recent assignment, more than 75% of the guideline candidates that qualified on size and correspondence of industry were eliminated because 80% or more of their revenues came from sales of manufactured product with the balance from services, while the subject was a pure service provider with no product sales.

In many high-tech businesses with short product life cycles, operating trends can change dramatically: a \$20 million company that had \$10 million in sales in the prior year is very different from a \$20 million company that had \$24 million in sales in the earlier period. Moreover, the market's treatment of both might be inapplicable when the subject has had a stable sales base ranging from \$6 million to \$7 million over the past few years.

It all comes back to The Big Three. Before selecting a company as a guideline, the appraiser has to confirm similarity of markets, operations, and trend. Failure to do so will lead to unsupportable conclusions.

RMC followup:

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IBA News, November 1999, page one of blue insert.