White Paper

Understanding Value Drivers

6 Drivers that Can Dramatically Impact What Buyers Will Pay for Your Business

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Understanding Value Drivers

Value Drivers are critical to improve the performance of your business today and its value for tomorrow. Why? They encapsulate what potential buyers look for in acquisition targets and help maximize business value for your future exit. It's your job as the owner to create value within your business.

What Value Drivers Help You Accomplish

1. *Improve Performance and Achieve Growth* – What business owner doesn't want to grow and improve things like profitability and cash flow? Focusing on Value Drivers can help achieve these sometimes elusive goals.
2. *Reduce Stress and Free Up Time* – Several of the Value Drivers lead to a reduced reliance on the owner, which increases the value of a business. This has the added bonus of lessening stress and allowing for some much needed vacation time for otherwise overloaded owners.
3. *Maintain Business Continuity* – We often remind our clients that they will eventually exit their business and that, unfortunately, not all owners are so lucky as to exit at the time of their choosing. Focusing on Value Drivers makes those unplanned exits less devastating to the business.
4. *Make Your Business Attractive to Potential Buyers* – This is important for attaining exit objectives when it is time for the owner to leave the business.

Value Drivers are characteristics that either reduce the risk associated with owning the business or enhance the possibility that the business will grow significantly in the future. It should be no surprise that the same characteristics that help a business perform and grow also attracts buyers, who evaluate risk and return as with any other financial investment.

There are many factors that create value including proprietary technology, market position, brand, diverse offerings, intellectual property, etc. We will look only at those key Value Drivers that are common to most businesses.

Six Value Drivers Defined

The six Value Drivers common to all industries are:

- A stable, motivated management team
- Operating systems that improve sustainability of cash flows
- A solid, diversified customer base
- A realistic growth strategy
- Effective financial controls
- Good and improving cash flow

1. Your Management Team >>>

One of the most important Value Drivers in any business is its management team. This team is comprised of those people who are responsible for setting company objectives, monitoring its activities, and motivating the workers. In many small companies, this "team" consists of one person; generally the owner. To build a championship-caliber organization, however, the management team should include people with a variety of skills. Surrounding yourself with quality people whose skills are different than yours may help you focus on what you do best and enjoy the most, free up some of your time, reduce stress, and increase the value of your business.

Good teams are hard to assemble, and even harder to keep together. If a good management team is in place, the probability for continued success is good. In the investment banking business, the adage is: "Great management teams are worth their weight in gold, because no matter what happens, they find a way to win."

A Buyer's Perspective

Having a solid management team in place increases value because it reduces risk for a potential buyer. In most cases, negotiation over sale price and transaction structure revolves around the buyer's perception that future cash flows will not match, much less exceed, historical results. When buyers evaluate this risk, they focus on whether or not the existing management team is able, and willing, to grow the business. The stronger the management team, the higher the price. If the buyer perceives your business to be dependent upon your personal relationships and reputation alone and subsequently concludes that, in essence, you are the management, the buyer will not pay a premium price.

If a company has a solid management team, a buyer will likely assume that customer relationships can be maintained, and that the company's reputation will remain intact.

Buyers conclude that the company will continue to grow with the existing management and will demonstrate their confidence in future cash flows by paying a higher sale price.

How to Keep Management in Place

How, then, do you keep management in place? If you plan to stay in your business for at least a year, then consider an incentive compensation system, cash or stock-based, that rewards key employees as the company performs (usually measured by increases in pretax income).

Part of incentive compensation should be paid currently and part deferred to be received by key management only if they stay long-term. This deferred compensation is typically subject to vesting.

If you are planning to sell the business now, then a long-term incentive package is not appropriate. Instead, your best bet is to keep your key management by paying them lots of money in the form of additional salary and performance

bonuses. In the short term, it is usually possible to "buy" key management's continued presence.

An example of a cash bonus plan appropriate for the company facing imminent sale is to reward management in the form of cash bonuses based on increased company cash flow. In short, create a "pot" from which management receives perhaps 10 to 25% of the increase in profits over the previous year. If, in this example, cash flow was $1 million in the previous year, award management 10 to 25% of the increased cash flow, payable quarterly in the current year. It is important to base the award on increases in cash flow or profitability and to pay the bonus during the current year. To be meaningful, bonuses must be substantial and frequent.

Providing significant short-term bonuses recognizes that you cannot afford to lose your key employees just as you begin the sale process. Paying them sufficient money means they cannot afford to leave the business.

Management & Culture

The final motive for maintaining stable management is to foster a healthy corporate culture. High employee turnover may negatively affect the value of the company and will be examined quite closely by any potential buyer. Consider implementing programs to improve employee morale thereby reducing employee turnover. These programs need not be costly and may include:

- Informal, social get-togethers
- Verbal or written appreciation that becomes part of the employee's work file
- Flex time, such as late arrival or departure, or extended four-day work schedules
- Time off awarded after completing a job "above and beyond the call of duty" or awarding over-time compensation
- Improved potential for promotion
- Pleasant work facilities
- Assignment of challenging work
- Company-sponsored continuing education
- Frequent staff meetings to elicit employees' suggestions and to address concerns (Be sure comments remain confidential and that, if possible, management works on improvements),
- Periodic attitude surveys to measure job satisfaction and employee concerns.

2. Your Operating Systems >>>

In addition to building a solid management team, owners must also build reliable operating systems and processes that sustain the growth of the business. It’s important to develop, document and continually improve business systems that generate recurring revenue from an established and growing customer base. If you remove yourself from your company, what remains? If the answer is capable management and highly efficient business systems, the value of your business will be positively impacted.

Business systems include the computerized and manual procedures and processes used in the business to generate revenue and control expenses, (i.e. create cash flow), including how customers are identified and retained, how products or services are delivered, and how employees produced intended business results. The establishment and documentation of standard business procedures and systems supports business continuity and helps assure continued profitability.

There are several business systems that, once in place, enhance business value. Examples include:

- Personnel recruitment, training and retention
- Human resource management (an employee manual)

- New customer identification, solicitation, and acquisition
- Product or service development and improvement
- Inventory and fixed asset control
- Product or service quality control
- Customer, vendor and employee communication
- Selection and maintenance of vendor relationships
- Business performance reports for management

Obviously, appropriate systems and procedures vary depending on the nature of a business, but, at a minimum, those resources and activities necessary for the effective operation of the business should be documented.

3. Established and Diversified Customer Base >>>

Another Value Driver is the development of a customer base in which no single client accounts for more than 10% of total sales. A diversified customer base helps to insulate a company from the loss of any single customer. Achieving this objective can be problematic when you are building a business with limited resources and one or two good customers are willing to pay for everything you can deliver. If this is the situation in which you find yourself, it's important to reinvest your profits into additional capacity that makes developing a broader customer base possible.

4. Realistic Growth Strategy >>>

Growth is great in and of itself. It is also important in increasing the value of a business. To demonstrate, let's address a growth strategy for an existing company.

Buyers pay premium prices for companies that have a realistic strategy for growth. That strategy must be communicated to a potential buyer in such a way that a buyer is able to see specifically why cash flow and the business as a whole will grow after it's acquired. The growth is illustrated in pro forma statements that will be used by buyers and investment bankers when formulating a discounted future cash flow valuation of your company. This valuation typically determines what a buyer will pay for your business.

Since future cash flow is based on estimates of future growth, having a realistic growth strategy is vital to reaping top dollar for your business. A growth strategy can be based on:

- Industry dynamics
- Increased demand for the company's products based on population growth, etc.
- New products and new product lines
- Market plans
- Growth through acquisition
- Expansion through augmenting territory, product lines, manufacturing capacity, etc.

Without a written plan, don't expect a buyer to appreciate the growth opportunities your company offers. A buyer won't understand your business as well as you do, and will not likely see its hidden opportunities. Also, if a buyer does discover an opportunity that he believes you've ignored, he will likely attempt to take advantage of that knowledge during purchase price negotiations. Even if you expect to retire tomorrow, you need to have a written plan describing future growth and how that growth will be achieved based on the areas listed above as well as any other bases for future growth unique to your business. It is this growth plan, properly communicated, that will attract buyers.

5. Effective Financial Controls >>>

Another key Value Driver is the existence of reliable financial controls used to manage the business. Financial

controls are not only a critical element of business management, but also safeguard a company's assets. They help businesses achieve consistent profitability.

To illustrate the importance of financial controls in increasing business value, let's consider the sale of a business. In the purchase of a business, the buyer will perform some level of financial due diligence. If the buyer's auditors are not completely comfortable when reviewing your company's past financial performance, you have no deal or, at best, a reduced value for your company.

Once again, put on the buyer's shoes. You are buying a company that you likely had not heard of three months ago. And, the current owner asserts that the company has been making $1 million per year for the past three years and is projecting to make at least that much in the future. Your first thought would be: "prove it." If a seller then produces past financial statements that prove incorrect, insupportable, or incomplete, you'd be highly skeptical, or, more likely, simply gone. You would never pay millions of dollars without knowing for certain what the company's cash flow has been. You need to have complete confidence in the past financial activity of that company.

The best way to document that a company has effective financial controls and that its historical financial statements are correct is through a certified audit; or perhaps a financial statement verified by an established CPA firm. The lack of financial integrity is one of the most common hurdles encountered during the sale process.

Business owners universally perceive financial audits to be an unnecessary expense, or, at best, a necessary evil required by their banks. In reality, an audit is an investment in the value and the marketability of your business. The best way to demonstrate the sustainability of earnings is to have your historical financial statements audited and co-reviewed by an independent, certified public accountant. An audit demonstrates to potential buyers that the historical information can be relied upon when making judgments about purchasing the company based on historical cash flows. Just like any publicly-traded security, buyers of private businesses want to have confidence in the historical financial information. It bears repeating that the best way to instill that confidence is through an independent audit of the company's books.

The Importance of
Financial Controls

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When do you need to begin financial audits of your company? There are three traditional levels of "accountability." The first is un-audited financial statements that your company's CPA prepares for you and perhaps for your bank. The CPA firm makes no representations as to the accuracy of those financial statements. It is highly unlikely that any buyer of a midmarket company would give those financial statements any weight whatsoever except as a preliminary idea of what the company says it has done. They may be the basis for discussions but certainly not the basis of a purchase.

The next level of accountability is a reviewed statement by your CPA firm. This means that the CPA firm has reviewed the financial information and has determined that it is accurate based upon your representations to the CPA firm. It is not uncommon to see sales of midmarket companies in which the buyer required only reviewed statements. The final level of accountability is verification by a CPA firm that the information contained in the financial statements is accurate based upon its own investigation.

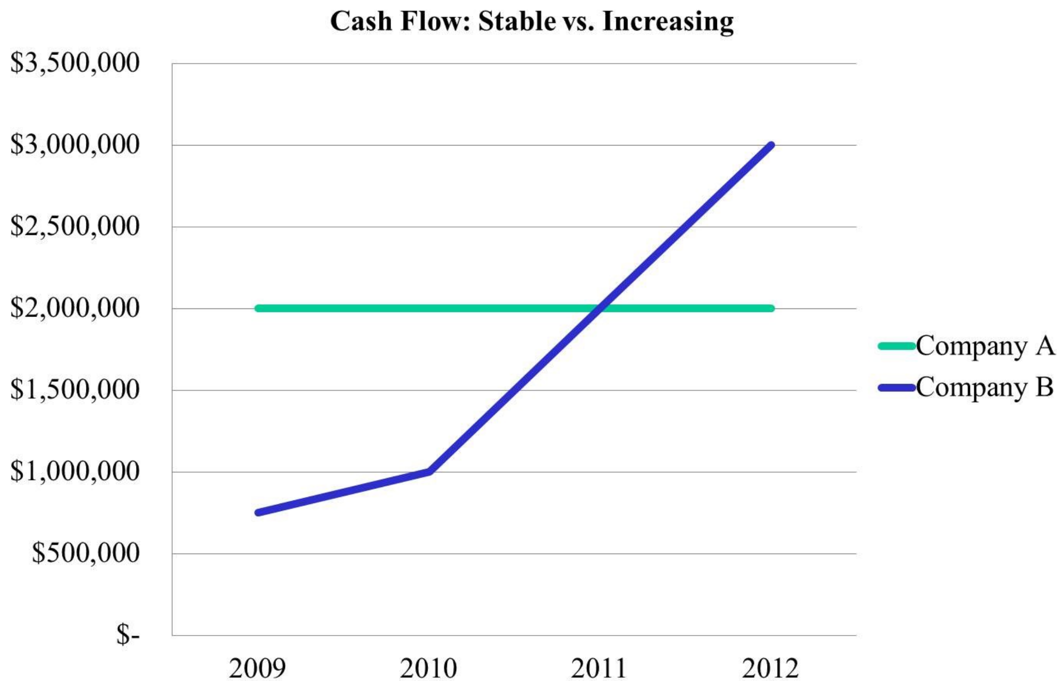
Put yourself back in the buyer's shoes once again. Which level of assurance is most desirable? Which makes you more willing to pay top dollar for a company? Obviously, it is the independently verified financial information and not the unverified representation of a business owner anxious to leave his business.

For this reason, it is likely that audited or reviewed financial statements will be necessary. These probably do not

need to be prepared until you have started the sale process. It is very important to engage the services of a recognized, reputable CPA firm to begin a review of your current financial statements and practices. The purpose is to uncover any financial irregularities or inadequacies as soon as possible so that you can correct them immediately.

6. Stable and Increasing Cash Flow >>>

Ultimately, all Value Drivers contribute to stable and predictable cash flow. It is the cash flow that determines what a buyer will offer to pay. Buyers buy cash flow- and they pay top dollar for cash flow that they expect to increase after they buy the company. Think like a buyer. Which cash flow chart below looks better?



Notice that the total cash flow for each company is the same, $6 million over the last three years. Yet, company B has a better story to tell because its immediate past and present cash flow have improved and continue to improve. It is important, especially in the year or so preceding the sale of the business, that cash flow be substantial and on an upswing. The buyer will also look for earnings of the company to continue to increase through the sale process itself (which can take a year or more). Perhaps the critical question is: How do you go about increasing your company's cash flow?

Reinvigorate yourself. Pay greater attention to increasing cash flow through simply operating the business more efficiently. Sit down for thirty minutes (or longer!) and think about all of the ways your company can improve its cash flow. Concentrate on the methods that you've declined to pursue because you and the company are comfortable with the "way things are."

If you have become a semi-absentee owner, spend more time at the office. You, more than anyone, will discover many ways to increase productivity, decrease costs, and increase cash flow.

Implement specific procedures to increase cash flow. These may include tightening the reins on the purchasing department, or reevaluating your investment in advertising. Do you have the best possible people in charge of these areas? Have you provided them the economic incentive to maximize cash flow for the business?

Stop using the business as your personal pocketbook (if applicable). Many owners seize the opportunity to use the business to pay for all kinds of hidden perks. These are the types of expenses that are difficult to recast because they

are not actual out-of-pocket expenses but are "soft costs." These activities depress and deplete cash flow and simply cannot be factored back into the sale price via recasting earnings.

List the ways you benefit financially from the company. This list will help your advisors “recast" the cash flow to account for cash flow diverted to you that would be available to a purchaser, thereby increasing the purchase price.

Your list should include above market compensation for yourself, family members, close friends and other relatives.

It may also include cars, vacations, recreational vehicles or above market rental payments for assets you own and lease to the company.

Don't play games with the balance sheet, particularly in inventory and accounts receivable.

Carefully scrutinize employee benefits, including discretionary compensation items, such as bonus plans and qualified retirement plans.

Defer unnecessary capital expenditures. Eliminating or deferring all non-essential equipment purchases can improve the bottom-line, increase cash flow and thus increase the potential selling price.

Conclusion

These Value Drivers are time-tested and proven, but tackling them alone can be challenging. Engaging the assistance of trusted advisors can improve your results.

Business owners who adopt and implement these Value Drivers have seen a significant improvement in the value of their business. They have improved performance and stimulated growth. They’ve also reduced their stress and freed up time. And, they’ve made their business more attractive potential buyers and given themselves more control over when and how they eventually exit their business.

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