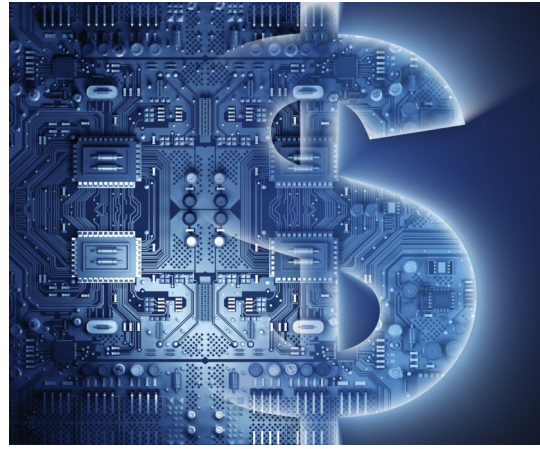


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Build a Company Future Buyers Want to Invest In: Value Creation Model

By John M. Collard



Valuing a company is the easy part; creating that value in the first place so you have something to measure is a more formidable task. Create a Value Equation to build *worth* into a company.

Determining value is more art form than science. True value can only be established at the time of a transaction, where a willing buyer tenders payment and a willing seller accepts it in exchange.

Buyers and sellers look at the component make-up of a company differently, therefore, place different values on these ingredients and on the whole. To enhance real company value, analyze company components as they relate to *worth* in the mind of potential buyers. Value to one buyer does not necessarily hold the same value for another. Establish multiple buyer profiles depending upon the circumstances, and prepare to build value each would be willing to pay for. There are essentially two kinds of buyers, Strategic and Annuity Buyers, both with different motives.

The Strategic Buyer purchases for reasons that fit into their long-range plan. They benefit through synergies like acquiring customer base in expanded territories, new products, added capacity, reduced costs, etc.. This buyer may place some value in first line management team, but will see added value in the ability to place their own managers into key positions.

The Annuity or Financial Buyer sees value in a stand-alone entity's ability to generate cash flow from profits year after year. The institutional buyer places the highest value on how motivated and incentivized the existing management team is, and their receptiveness to remain to generate cash and profits. The owner/operator conversely will look at 'buying a job'.

Typically, strategic buyers of closely held companies purchase at six to 10 times earnings and/or cash flow, while annuity buyers pay two to six times cash flow. The ultimate worth of the company de-

pends upon who the buyer will be. These multiples are usually considerably higher in public companies, but the concepts of building value are the same.

From the start, plan to sell the business and put value creation into perspective. Free cash flow and the continued ability to produce it with reliable probability creates the greatest value. This is not as easy as it sounds. In fact, it can be complicated, is often misunderstood, and frequently is bungled. Look at the elements in the *Value Creation Equation* to see how each brings forth value and how together they compound the effect.

$$\text{Value Creation} = \text{Net Asset Value} + \text{Future Revenue Stream} + \text{Going Concern Value} + \text{Incentive to Purchase}$$

Net Asset Value (NAV)

Sometimes called Orderly Liquidation Value, it is the cash net worth of assets less encumbrances if you were to liquidate these assets at a fair market price under orderly disposition conditions when liquidation is not necessary. This NAV can equal Net Worth on the Balance Sheet, but is often adjusted for the value of intangibles.

Simply stated: Tangible Unencumbered Book Value + Intangible Assets + Adjustments to Market Value (Over-amortized/depreciated/expensed assets, or usable Inventory written down lower than market value) - Obsolete Inventory and Bad Debts - Outstanding Obligations on open contracts = market value. Build a strong, healthy balance sheet with adequate reserves and proper statement of asset value, because this is a fundamental on which to expand company and increase its worth.

Tangible assets can be appraised to establish their worth. Conversely, intangible assets are harder to value because they are subject to interpretation. If you sell a machine you realize cash for the transaction; but if you lose a customer, no one pays you for it, they're just gone. Intellectual property is also hard to value, but filing more patents will generate value, particularly to those who can afford to protect them from infringement.

The real opportunity lies not in building asset base, but in building maximum return on that deployed capital. If assets sit idle, they are actually losing value, but if volume causes assets to work to produce output production, value is being created.

The closer relationship of assets to realize \$1 for each \$1 dollar on the balance sheet the better. Cash and Securities fit this description. Accounts Receivable will be discounted as they age, focus on keeping the days outstanding low. Utilize percentage completion contracts when possible to keep receivables low and cash flowing.

Utilize just-in-time and consignment agreements to keep raw materials at low levels and minimize obsolescence. Produce in-process work expediently to cover short-term needs. Build finished goods for firm orders or reasonable short-term expectations of sale, don't overproduce. Cover the risk with orders for goods. Seasonable businesses should cover production levels over the off-season with contracts for sale of goods just before the season. It may be better to have less than market demand if projections were off, compared to interest and carrying costs to hold artificial Christmas trees until next year.

Customer Lists, contacts, name recognition, trademarks, reputation, Web distribution channels and Internet presence are often not considered in asset valuation because they are not carried on the balance sheet. These assets, however, are often worth considerable value in the marketplace. These assets can be turned

into cash, therefore, should equal the related value they could generate in return for their sale. These intangible assets can produce future sales, profits, and cash.

Future Revenue Stream

Real value in any company starts with its revenue stream, the more you can count on it occurring, the more value it has. The value becomes net present value of the after-tax free cash flow stream of revenue under contract, plus repeat customer base. *Contract backlog* is worth more than revenue that you must locate every year. The cost to re-create a sale each year is high in terms of time and human energy. Locate customers where multiple year contract environments can be set up. Government awards multiple year contracts. Many larger companies favor contract relationships with vendors to reduce the overall cost of screening vendors again and again.

While not as quantifiable as backlog, there is value in a *customer base* that's been maintained for a long period of time. The longer customers remain with a company, the more likely they will be loyal in the future. When customers stay with an organization, this is an indication of the value which they receive from that organization. Conversely, customer turnover indicates their dissatisfaction in the company's ability to provide services. For example, software companies retain customers and repeat sales with product upgrades and gain new customers with import utilities for easy conversion.

Clearly growth in revenue volume is an indicator of valuation in a company that investors are willing to pay for. If customers flock at above industry levels to a company for the services that they provide, this is a good indication of the company's ability to perform at above expected levels. A motivated sales force with the ability to generate new revenues year after year has more value than a company who has a poor selling reputation. A lack of growth indicates that the company does not have an ability to increase its value over time.

When a company has a believable prospectus for the future, the buyer will often plan additional capital investment to fuel growth. The buyer could be motivated to pay a higher valuation for the company and then invest on top of it.

Going Concern Value (GCV)

Here is where the fun begins in all transactions. The going concern value and goodwill, or soft assets, will always draw the most controversy and discussion in terms of their valuation. These elements are most prone to differing interpretation by buyer and seller.

Here too is where you can build the most value into a company. Buyers and investors look more to the company's ability to create additional value to enhance returns on invested capital as they hold their investment. Impart the elements that *Future Buyers* are looking for:

Businesses that create value. Consistency is key. You must demonstrate growth in revenue, profit and cash flow. Do everything in your power to eliminate and manage hiccups along the way. Audited statements go a long way toward verifying results, in spite of some recent press.

High probability of future cash flows. A history of positive cash flow at increasing levels is very important. True annuity buyers purchase cash flow, not the business. Strategic buyers will value cash flow plus what could happen if additional capital is provided. After all, free cash flow determines the periodic return on investment and increases the potential for a much higher purchase price in future.

Management team and human capital. Attract and motivate a marketing-oriented management team with the ability to produce recurring profits, return on capital, and free cash flow as an annuity for the owners. Develop an in-place stable, well-trained workforce to implement operating processes on an ongoing basis. This is the most valuable off balance sheet asset. When the owner of a privately held business has transitioned out and is collecting the net profit and cash without participating in an active management role, the value increases dramatically.

The ability to sell, compete, distribute, produce, develop products and thrive. This stand-alone entity's track record demonstrates the viability of the market relationship between the products/services offered to meet customer demand and need, ability of the company to compete, as well as the company's reputation in the marketplace. The more unique a product is, the more value it contributes. The company must be able to differentiate its products and services from the competition, even if this is based mainly on perception. Remember, products do have a life cycle and require improvements to remain in demand.

Leadership's role must be to build Going Concern Value. The GCV can be best maximized with stable leadership, setting and following sound strategies to consistently bring products and services to market, all the while nurturing resources and implementing processes to manage the company. Perhaps the greatest value resides here.

Incentive to Purchase

Create reasons for buyers to want to consider a company as an acquisition candidate. Buyers want a Fair Entry Valuation so that they can expect a realistic return potential. There must be Exit Options so that the buyer who buys your business can realize high ROI at the time they resell.

The better a company is at creating stakeholder value and shareholder return, the more interest there will be in buying some or all of the stock. While investors often buy on hope and promise, the dot com market collapse clearly indicates a need to ultimately produce returns to substantiate investment. Think for a moment, had many of the dot com managers built GCV to support their promising technologies, they might still be around today. Those that have built GCV have strong balance sheets, can weather the storm, and will undoubtedly find opportunities to gobble up assets from those who didn't.

Conclusion

Build on any one element in the *Equation* and you increase its individual value. Build up all elements in the *Equation* and you realize an exponential creation of value to the right buyer. The buyer looking for a standalone entity to produce an annuity stream will place the highest value on the company when all components are strong and it operates with little owner intervention. Buyers looking only for parts of a business to augment their own, will want to invest less and only place value on some components, regardless of how strong they are.

Remember, as in *Field of Dreams ...*
"Build It, they will come."

About the Author

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