Built to Sell: Value Creation Model

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

Buyers and sellers look at the component make-up of a company differently, and therefore, place different values on these ingredients and on the whole. To enhance the real value, analyze company components as they relate to worth in the mind of potential buyers. Value to one buyer often 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 buyers and annuity buyers, each with different motives.

Strategic buyers purchase for reasons that fit into their strategic plan. They benefit through synergies like acquiring customer base in expanded territories, new products, added capacity, and reduced costs. This type of buyer may place some value in the first line management team, but will see added value in the ability to place their own managers into key positions.

The annuity or financial buyers, on the other hand, see value in the 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 depends upon who the buyer will be. These multiples are usually considerably higher in public companies, but the concepts of building value are the same.

It is essential to look at what is valuable and understand how to exploit and preserve this value. 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.

Value Creation = Net Asset Value + Future Revenue Stream + Going Concern Value + Incentive to Purchase

The Breakdown

Net Asset Value (NAV)

Sometimes referred to as 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.

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 a company and increase its worth.

Utilize just-in-time and consignment agreements to keep raw materials at the lowest levels possible to 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. If in a seasonable business cover production levels over the off-season with contracts for sale of goods just before the season, cover the risk with orders for goods. 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 market place. The reasoning for this theory is that 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

A 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 the net present value of the after tax free cash flow stream of revenue under contract, plus repeat customer base. Contract backlog is worth much more than revenue that you must locate every year. The cost to re-create the sale each year is high in terms of time and human energy. Locate customers where multiple year contract environments can be set up. The government often awards contracts for multiple year periods. 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.

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.

When a company has a great, and believable, prospectus for the future, the buyer will often plan additional capital investment to fuel growth. If this case, 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. Transaction value is only at a point in time. 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 look for:

Businesses that create value. Consistency is the 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 the 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.

Incentive to Purchase

Create reasons for a buyer to want to consider your 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 the 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 sector collapse clearly indicated 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.

Ultimately, if you build on any one element in the Equation you will increase its individual value. Build up all elements in the Equation and you will realize an exponential creation of value to the right buyer.

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About the Author

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