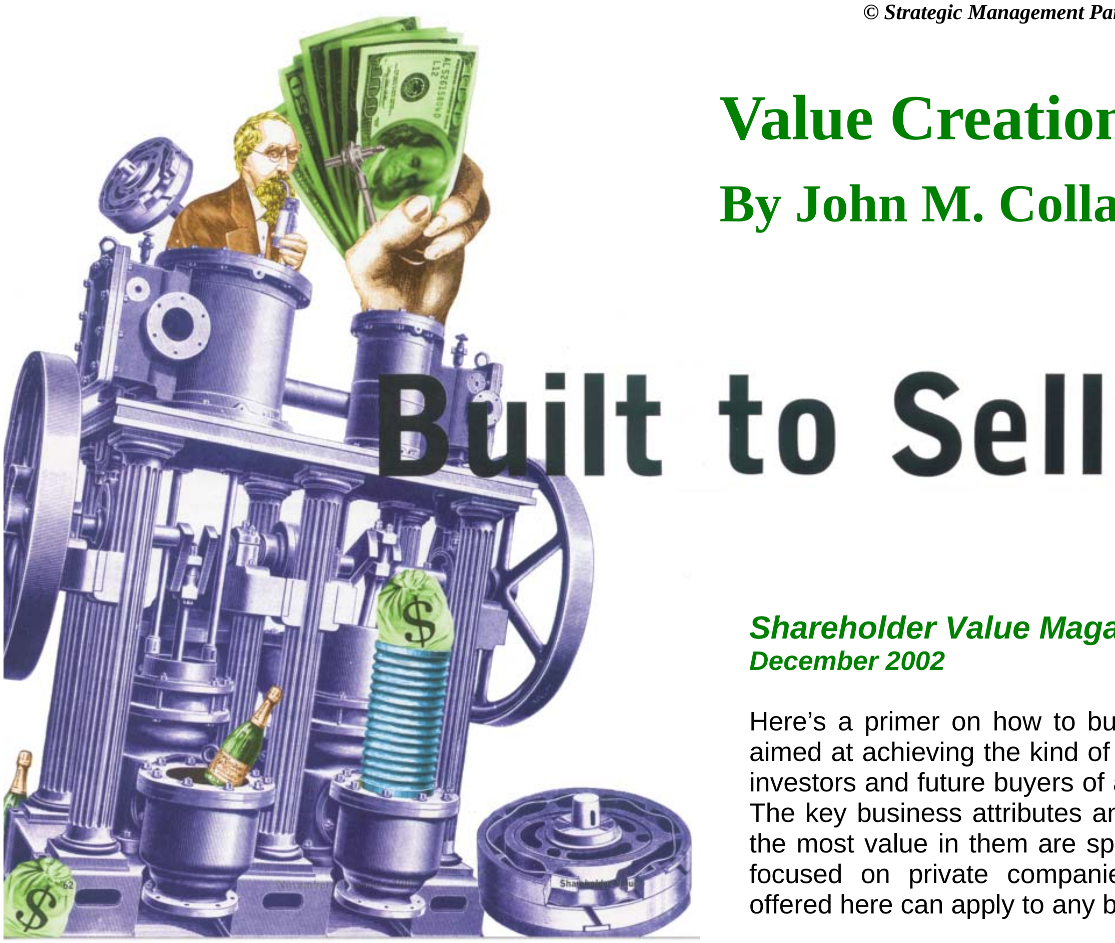
Value Creation Model

By John M. Collard



Shareholder Value Magazine
December 2002

Here's a primer on how to build a value creation model aimed at achieving the kind of steady growth that attracts investors and future buyers of a business itself. The key business attributes and how to create the most value in them are spelled out. While focused on private companies, the learning offered here can apply to any business.

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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.

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

Buyers and sellers look at component make-up of a company differently, and therefore, place different values on these ingredients and on the whole. To enhance the real company 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 and Annuity Buyers, both with different motives. Yet, both demand returns for their shareholders.

The Strategic Buyer purchases for reasons that fit into their strategic plan. They benefit through synergy like acquiring customer base in expanded territories, new products, added capacity, and reduced costs, et cetera. This type 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 Buyer, on the other hand, sees 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.

The essential, is 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

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.

Simply stated: Tangible Unencumbered Book Value + Intangible Assets + Adjustments to Market Value (Over-amortized/depreciated/expensed assets, or Inventory written lower than market value) - Obsolete Inventory and Bad Debts - Outstanding Obligations on open contracts = market value. Build a strong, 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.

About the Author

John M. Collard is Chairman of Annapolis, MD-based Strategic Management Partners, Inc., a nationally recognized turnaround management firm specializing in interim executive leadership, corporate renewal, and post-acquisition support for the private equity community. He is Past Chairman of the Turnaround Management Association; serves on public & private boards of directors; and is an author, speaker, advisor to companies, institutional and private equity investors, and governments. (410) 263-9100 www.strategist.ws

Tangible assets can be appraised to establish their worth. On the other hand, 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 those assets and deployed capital. Assets don't generate worth by themselves, they can only be used to generate worth. If the asset sits idle, it is actually losing value, but if volume causes the asset to work to produce output production, value is being created.

The closer the 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 as low as possible. 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 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. 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 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 to 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 'hick-ups' 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 important. True annuity buyers purchase cash flow not the business. Strategic buyers will value cash flow plus what will happen if additional capital is provided. After all, free cash flow determines the periodic return on investment and increases the potential for 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. When the owner of a privately held business has transitioned out and is collecting 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 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, and company reputation in the marketplace. The more unique a product is the more value it contributes to the deal. 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.

The directors' and management'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. Here is where the greatest value resides.

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 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.

Build on any one element in the Equation and you increase its individual value. Build up all elements in the Equation and you realize 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 a company when all components are strong and it operates with little owner intervention. Buyers looking 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. For example, if you build a strong senior management team, but a buyer wants to run the business, they will place no value in your senior managers that will be replaced.

Remember, as in *Field of Dreams:* "If you build it, they will come."