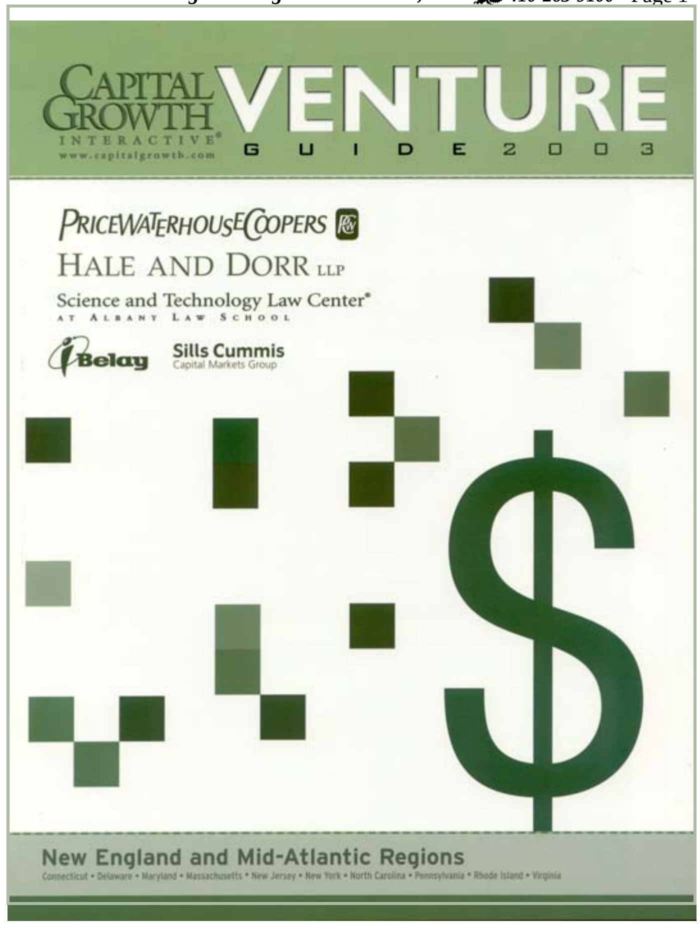

Value Creation Model: Build Enterprises Future Buyers Want to Invest In!

John M. Collard
Strategic Management Partners, Inc.

Valuing a company is the easy part; creating value in the first place so you can measure it is a more formidable task.

Determining value is more art form than science. True value can only be established at the time of a transaction, when Willing Buyer tenders payment and Willing Seller accepts it in exchange. Buyers and the seller 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 company value, analyze company components as they relate to worth in the mind of potential buyers. 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:

1. 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, etc. These buyers 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.

2. Annuity or Financial Buyers 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 the team's receptiveness to remain on hand 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. 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 — it can be complicated, is often misunderstood, and frequently is bungled. Look at the elements in the *Value Creation Equation* to see how they bring forth value and together compound the effect.

Value Creation =

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

Net Asset Value: Also known as Orderly Liquidation Value, is the cash net worth of assets less encumbrances if you were to liquidate assets at a fair market price under orderly disposition conditions when liquidation is not necessary. 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.

Tangible assets can be appraised to establish their worth. Intangible assets, on the other hand, are subject to interpretation. If you lose a customer, no one pays you for it, they're just gone.

Expert Editorial

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 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.

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. Yet, they can hold considerable market value.

Future Revenue Stream: The more you can count on a revenue stream 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 is high in terms of time and human energy. Locate customers where multiple year contract environments can be set up.

While not as quantifiable as backlog, there is value in a *customer base* that's been maintained for a long period of time. When customers stay with an organization, this is an indication of the value they receive from that organization. Conversely, customer turnover indicates dissatisfaction. Software companies retain customers and repeat sales with product upgrades and gain new customers with import utilities for easy conversion.

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

Going Concern Value: Here is where the fun begins in all transactions. The GCV and goodwill, or soft assets, will always draw the most controversy and discussion in terms of their valuation because they 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. You must demonstrate growth in revenue, profit, and cash flow. (Audited statements go a long way toward verifying results, in spite of some recent press.) 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.

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 a stable, well-trained workforce to implement operating processes on an ongoing basis. 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.

Additional value is realized in your company's ability to sell, compete, distribute, produce, develop products and thrive. Here, you are demonstrating 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 (even if this is based mainly on perception), the more value it contributes to the deal. Remember, products do have a life cycle and require improvements to remain in demand.

The role of directors and managers must be to build Going Concern Value! The GCV is best maximized with stable leadership.

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 buyers who buy your business can realize high ROI at the time they resell.

While investors often buy on hope and promise, the dot-com market sector collapse clearly indicates a need to produce shareholder returns to substantiate investment. Had many dot-com managers built GCV to support their promising technologies, they might still be around today.

Build on any one element in the *Value Creation Equation* and you increase its individual value. Build up all elements and you realize an exponential creation of value to the right buyer. Remember, as in "*Field of Dreams*" … "*Build It, they will come.*"

John M. Collard, a Certified Turnaround Professional, is Chairman of Annapolis Maryland-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 and private boards of directors, is a frequent author, speaker, and advisor to companies, institutional and private equity capital investors, and governments. To reach Strategic Management Partners, Inc., you can call 410-263-9100, or go online at www.strategist.ws