Value Drivers

A White Paper

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Did you ever wonder why one business has buyers lined up willing to pay top dollar while another sits on the market for months, or even years? What do buyers look for in a prospective business acquisition? The characteristics buyers seek must exist before the sale process even begins. It is your job as the owner to create value within your business prior to a sale.

The items, common to all industries, which drive up value, are called "Value Drivers." They include:

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

The reason a buyer is willing to pay a premium price centers on his or her perception of risk and return. If the characteristics that buyers find valuable — characteristics that both reduce risk and improve return — are present, a buyer will pay top dollar. Buyers will compare both risk and return to alternative investment opportunities. This investment principle applies to large publicly-traded investment opportunities as well as to private companies.

Value Drivers are characteristics of a business that either reduce the risk associated with owning the business or enhance the prospect that the business will grow significantly in the future.

There are many items that create value including: proprietary technology, market position, brand name, diverse product lines, and patented products. In this article, let's look only at those key Value Drivers that are common to most businesses, including: management team, business systems, customer base, facilities and equipment, business strategy, and financial controls.

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 is a necessary preamble to a successful sale.

In addition to talent, you need a management team with staying power. One of the first questions prospective buyers ask is, "Who runs the company and are they willing to stay?" If the answer is, "The owner is in charge, has not yet identified a successor, and wants to leave soon after closing," the value of the company plummets and most buyers look elsewhere.

Management teams are so valuable because good teams are hard to assemble, and even harder to keep together. Sophisticated buyers know that if a good management team is in place, prospects are good for continued success. 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."

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, then, do you keep management in place until you sell the business? If you are planning to sell the business upon finishing this White Paper, then any type of long-term, incentive planning is inappropriate. 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.

If you don't plan to sell 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. This type of plan is described in greater detail in Chapter Four of John H. Brown's book, *The Completely Revised How To Run Your Business So You Can Leave It In Style*.

No matter the length of the "pre-sale" period, it is crucial to keep your key management in place.

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 percent 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 percent 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.

The final motive for maintaining stable management is to demonstrate a healthy corporate culture. High employee turnover will be examined (quite closely) and may negatively affect the value of the company. Again, if your exit strategy is relatively short term, consider implementing programs within the company to improve employee morale thus 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); and
- Periodic attitude surveys to measure job satisfaction and employee concerns.

OPERATING SYSTEMS

In addition to building a solid management team, owners must also build reliable operating systems that can sustain the growth of the business. The second Value Driver then is the development and documentation of business systems that generate recurring revenue from an established and growing customer base. If you leave shortly after the sale of your company, what remains? If the answer is capable management and highly efficient business systems, you will be able to leave your business in style.

Business systems include the computerized and manual procedures used in the business to generate its revenue and control expenses, (i.e. create cash flow), as well as the methods used to track how customers are identified and how products or services are delivered. The establishment and documentation of standard business procedures and systems demonstrate to a buyer that the business can be maintained profitably after the sale.

Put yourself in the shoes of the would-be buyer for a moment. As a buyer, you want assurance that the business will continue to move forward under new ownership, and that the operations will not break down if (and when) the former owner leaves. This assurance can best be obtained when there are documented systems in place that will enable the buyer to repeat the actions of the former owner to generate income and grow the business. There are several business systems that, once in place, enhance business value whether you plan to sell your business now or decide to keep it. These procedures cover:

- 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; and
- 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.

ESTABLISHED AND DIVERSIFIED CUSTOMER BASE

Put on those buyer's shoes one more time and you'll find yourself shuffling past companies with great management teams and excellent systems but whose cash flow is dependent on one or two customers. Why spend millions of dollars on a business only to have those customers go elsewhere after you've acquired the company? At the very most, a prudent buyer will structure a buyout to protect against the loss of a key customer, probably by making much of the purchase price contingent or requiring the seller to carry a note for the bulk of the purchase price. As a seller, binding your financial security (for several years) to your former company and its customer is the last scenario you'd prefer.

Another Value Driver, then, is the development of a customer base in which no single client accounts for more than 10 percent 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 is important to reinvest your profits into additional capacity that will make developing a broader customer base possible.

APPEARANCE OF FACILTIY CONSISTENT WITH ASKING PRICE

Although matching the business's "face" to its asking price is not usually a problem for business owners, some owners can be, shall we say, "economical" when devoting financial resources to the physical appearance of their places of business, or their business equipment. This is more often true of businesses whose facilities are not visited by the general public; for example, the offices of a phone-based or off-site sales organization, or a manufacturing or warehouse-based business. However, for the same reason that your retail facility is top notch, your other "hidden" facilities must also appear first class. Keep in mind, you are about to show those facilities to a new customer—a potential buyer of those facilities.

Admittedly, there is no reason why a new owner of the company would need better appearing facilities than yours because those facilities have gotten you where you are today. But, if the buyer is being asked to *pay* millions of dollars for your company, he will want the business to "*look like* a million dollars."

Besides, a good-looking facility shows buyers that you are proud of your business in every respect and that you have made the necessary investments to keep it going. It also indicates that you have not deferred making necessary capital investments only to create future capital investment requirements for the buyer.

Finally, a clean, well-organized office communicates the message that the business is also clean and well-organized. It is amazing how a few thousand dollars of superficial improvements can improve the marketability of your business and increase the interest of potential buyers.

REALISTIC GROWTH STRATEGY

Buyers pay premium prices for companies having a realistic strategy for growth. That strategy must be communicated to a potential buyer in such a way so that a buyer can see specific reasons why cash flow and the business itself will grow after it is 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. That growth strategy can be based upon:

- Industry dynamics;
- Increased demand for the company's products based upon population growth, etc.;
- New products and new product lines;
- Market plans;
- Growth through acquisition (See the White Paper, "Growing Your Business Through Acquisition"); and
- 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. First, a buyer will not 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 have 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 that growth plan, properly communicated, that will attract buyers.

Building and documenting a positive growth story, however, is only 90 percent of the game. The remaining ten percent is knowing how, when, where and to whom to tell your story. The storytelling takes place during the sale process and is done with the guidance and assistance of an investment banker or other transaction intermediary. That is the time when you force savvy buyers (meaning those with lots of money) to pay for the value you have created in your business.

EFFECTIVE FINANCIAL CONTROLS

Another key Value Driver is the existence of reliable financial controls that are used to manage the business. Financial controls are not only a critical element of business management, but also safeguard a company's assets. Most importantly, however, effective financial controls support a claim that a company is consistently profitable.

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 those buyer's shoes. You are buying a company that you likely had not heard of three months ago. You face an owner of a business who asserts that the company has been making $1 million per year for the past three years and is projected to make at least that much in the future. Your first thought must be: "prove it." If a seller then produces past financial statements that prove incorrect, insupportable, or incomplete, you will 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 the company has effective financial controls and that its historical financial statements are correct is through a certified audit or perhaps a verified financial statement 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.

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 mid-market 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 mid-market companies in which the buyer required only reviewed statements.

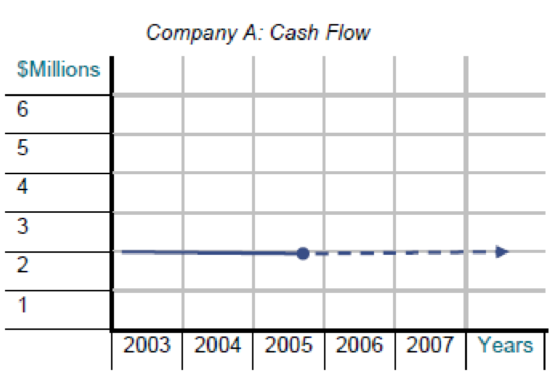
The final level of accountability is verification by a CPA firm that the information contained in the financial statements is accurate based upon its own investigation.

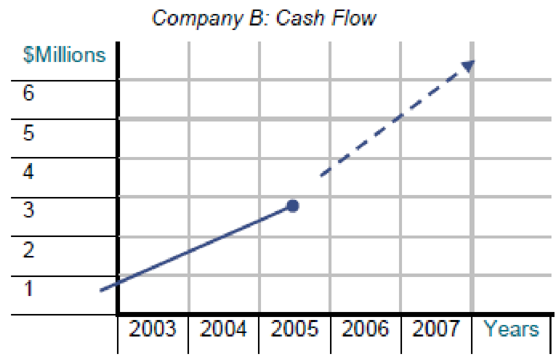
Put yourself back in the buyer's shoes one last time. Which level of assurance is most desirable? Which makes you more willing to pay top dollar for a company? Obviously it is the independently verified financial information and not the unverified representation of a business owner anxious to leave his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

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 earnings chart below looks better?





Notice that the total cash flow for each company is the same, $6 million over 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 excessive compensation for yourself, family members, close friends and other relatives. It may also include: cars, vacations, recreational vehicles or excessive rental payments for a building or equipment you rent 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 bonuses 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 sale price.

CONCLUSION

Whether a buyer will pay a premium price for a business depends, in large part, upon the efforts of the owner to adopt and implement the Value Drivers described in this Paper. These Value Drivers were not dreamed up by a business school professor but are what professional, sophisticated buyers tell us they seek in closely-held businesses. Concentrating on developing and enhancing each Value Driver will position you to get a premium price for your business.

At Houston Harbaugh, Jim Carlisle and Erin Farabaugh specialize in structuring, negotiating, documenting and closing mergers, acquisitions, divestitures and reorganizations, and serve as corporate counsel for regional, national and international privately-held companies. They also advise emerging businesses in all stages of development, from formation to a liquidity event.