



# THE CAPITAL CORPORATION

*Closing Deals. Opening Doors.*

## **A Case Study: Reducing Business Risk to Increase Business Value**

It is a fundamental truth that a business with less risk is more valuable to any given purchaser than a business with more risk. The amount of purchase price a purchaser is willing to pay for any earnings history will be “risk adjusted” for the perceived risk of whether that earnings stream will continue into the future. Therefore, one way to increase value is to lower the various risks that impact a business.

The owner of a multi-location wholesale distributor of industrial plumbing supplies had been approached by a competitor with an interest in selling his business. He was of course, flattered and was interested because the timing was right for him personally. After sharing information and some extensive due diligence the owner was presented with an offer. Unfortunately, the offer was well below his expectations and he declined the offer.

Rather than getting upset and since he respected the company that had made the offer, the owner assumed that the potential purchaser had a good business reason for the offer they made. The owner came to The Capital Corporation for assistance in determining what aspects of his business would have caused the disappointing value and what could be done about it.

The Capital Corporation conducted a thorough review of his company and compared his operation to the industry norms both from an earnings standpoint as well as from a risk profile standpoint. It was determined that earnings were slightly less than the industry norm and that this resulted from the company’s marketing strategy. Most companies in this industry basically stock the same general type of inventory, even if there are different brands. Therefore the customers perceive these vendors as providers of commodity products and aggressively shopped for the best price. The subject company had done nothing to effectively differentiate itself on anything other than price. Therefore, the purchaser perceived the risk of customer retention to be high.

Based on our analysis, the Company implemented a strategy to differentiate itself on something other than price. After surveying their customers, the Company determined that the one factor more important to their customers than price was having the part they needed in stock. Therefore, the Company made the conscious decision to invest in a more sophisticated inventory management system that allowed them to have better visibility on their in-stock inventory; to do a better job of maintaining the highest moving items in stock; and replenishing inventory more quickly. They then design a

marketing campaign around a guarantee that they would have any part in their catalogue in stock or it would be drop shipped to the customer the next day with no shipping charges.

The Result – The Company was able to significantly reduce their out of stock orders and was able to increase their gross margin by over a three year period putting their earnings at a level above industry norms. More importantly they established a more loyal customer base that was not always looking for the best price but was looking for guaranteed availability of parts. This loyal customer based, in turn resulted in a reduction in the perceived risk in an M&A transaction thereby increasing the valuation multiple of earnings.