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What Drives the Value of your Business?

By Alan D. Austin, CFA

Why do entrepreneurs own and operate businesses? Many of the answers include; providing the owner with an income, financial independence, providing jobs for the community, providing a much needed product to the market and creating a legacy. While these and many more aspects are part of the answer, the bottom line is that entrepreneurs own and operate businesses to create value.

Value creation is the key to sustaining a business. As the value of a business enterprise grows the business is able to provide the business owner with the opportunity to achieve many of his or her goals, some examples of which include:

- Financial Independence
- A Stable Personal Income
- Job Creation
- Support of Their Local Community
- Obtain a Certain Level of Respect in the Community
- Better Access to Capital Markets (Bank Loans, etc.)
- Ability to Attract and Hire the Most Talented Individuals
- Enough Wealth to Provide a Comfortable Retirement

While this last goal may not be the main driver when an entrepreneur starts their company it is commonly the most important goal as the business owner begins to think about an ownership transition strategy and the ultimate sale of their business.

Therefore, the biggest question on any business owner's mind should be What Drives Value?

The answer is simple, an unrelenting focus on two things: Increased Earnings and Reduced Risk. Even though the answer is simple, it is not necessarily easy to manage these drivers. Let's take a look at these two factors and what a business owner can do to manage them.

Earnings can be defined in a variety of ways beginning with Gross Profits and including other levels of earnings such as Operating Profits, Pretax Profits, Net Income and EBITDA (Earnings Before Interest,

Taxes, Depreciation and Amortization). When it comes to selling a company, business owners become very familiar with the term EBITDA, which is also commonly referred to as Cash Flow. The valuation discussion quickly boils down to what multiple of EBITDA is appropriate, for example, 4 times EBITDA vs. 8 times EBITDA. Whether the multiple is a 4 or an 8 or even lower or higher or somewhere in between is a function of the second value driver, Risk. More on that later for now let's focus briefly on Earnings.

I say briefly because creating earnings, in theory, is pretty straight forward: revenue minus production cost minus general & administrative costs minus interest and taxes equals earnings. Simply put, maximize revenues and minimize costs. We all know it is not that simple. Maximizing revenue is a complex balance of having the right amount of production capacity; detail pricing strategies, the right sales & marketing approach and an effective product or service delivery system.

Managing costs is equally complex as business owners have to source quality raw materials at acceptable pricing; hire the best employees possible; and negotiate the best prices possible from a myriad of suppliers ranging from insurance providers, accountants, bankers, transportation companies, utilities, unions, etc. Most business owners already know what they have to do to increase earnings, whether they are able to accomplish it or not is another question. Although creating earnings may vary from business to business, the point I am trying to drive home is that without earnings, value is going to be limited to the liquidation value of the company's hard assets. Even though you may have to pay more taxes, pursue an unceasing quest for increased earnings, EBITDA, if you want to increase the value of your business.

I truly believe that the second value driver, Risk, is the most overlooked aspect of managing a business by most entrepreneurs and, consequently, in maximizing the value of their business. The fundamental truth is that a business with less risk is more valuable to any prospective purchaser than one with more risk. The amount of purchase price a purchaser is willing to pay for your earnings history will be "risk adjusted" for the perceived risk of whether that earnings stream will continue into the future. What kind of risk, you may ask? The answer is every kind of risk, but more on that later. First, it is time for a math lesson.

As we all know risk is measured by the rate of return required to persuade an investor to make a particular investment, in this case, buy your company. If the perceived risk of buying a certain company is high, then the required rate of return will be high, let's say 25%. If the perceived risk is low the required rate will be lower, let's say 12.5%. So what does this have to do with the multiple of EBITDA we discussed earlier? Interestingly, these multiples, for example 4 times or 8 times, are simply the inverse of the required rates of return. So, a 25% (or .25) return is the same as a multiple of 4 because $1 / .25 = 4$. Similarly, 12.5% (or .125) is the same as a multiple of 8 ($1 / .125 = 8$). The result, higher risk equals higher required rate of return equals lower multiple equals lower valuation. Now that we understand why risk matters, let's look at risk and how to manage it.

I said earlier that risk comes in all sorts of varieties, most of which can be managed or mitigated (with insurance) and some of which can not. While preparing business valuations, I group risks into one of five broad categories as follows:

- 1) Industry Profile
- 2) Financial position of the Company
- 3) Level of Diversification
- 4) Depth of Management
- 5) Competition

The process of managing the various risks in each of these categories will vary for each individual company. In addition, the list of risk factors in each category will vary from company to company. As a business owner, it is part of your job to constantly evaluate the various risk factors in each category and decide which ones you think you can manage the most effectively. These will be the risk factors you focus on the most. Let's look at each of these risk categories.

Industry Profile – This category represents the risks associated with the broad industry in which you operate. Some industries are very stable and some are very cyclical, like construction. Some industries are mature and established while others are young, high growth and volatile (high risk). You may think that there is nothing you can do to mitigate industry risk because you can't change your industry. You may not be able to change your industry but you can certainly change the way you operate in your industry. For example, if you operate in a cyclical industry, attempt to find a customer base that is more stable than the obvious customer base. We had a client that was a general contracting company that was primarily a residential builder. After analyzing their industry and identifying the cyclical risk in residential construction they totally changed their customer focus and now 100% of their business is office up-fit construction. They found that companies moving in to new office space that needed up-fit services generally were financially healthier and easier to work with than homeowners and therefore, less risky. Also, office up-fit, although still cyclical, was less cyclical than new construction. Analyze your industry, identify the risks and develop a business strategy to eliminate or mitigate the risks.

Financial Position of the Company – The risks represented here result from the financial profile of your individual company. Again the list can be long and varied but includes items such as, too much use of bank debt; relying too heavily on the credit extended by your vendors; carrying too much inventory; under utilization of fixed assets and lack of profitability, to name just a few. It is relatively easy to obtain financial ratio averages for various industries from sources such as Risk Management Associates (RMA). Your banker probably uses these ratios to analyze your company and should be willing to share the industry standards with you. Obtain these ratios for your industry and compare your company to the industry average. Where you are below the averages, take corrective actions so

you are exceeding the industry norm in all areas. This translates into lower perceived risk and a higher valuation.

Level of Diversification – Diversification in business is generally a good thing. Lack of diversification is a bad thing and can affect many areas within a company. Probably the area most of us focus on is customer diversification or the opposite of that, customer concentration. In addition to customer diversification, business owners should be aware of the increased risk of having a lack of diversification among its raw material suppliers; sources of capital (banks) and even access to an adequate work force, to name just a few. Having a handful of large customers can be intoxicating but the loss of one or two of these can be devastating to the company. Business owners should constantly work to diversify their customer base and to develop back-up suppliers of raw materials. I once performed a valuation on a highly profitable company that had only one customer. This was such a significant risk to the company that I placed a high required rate of return on this investment. This resulted in a low valuation that was obviously disappointing to the owner. In fairness to the appraiser, the loss of this one customer would have taken the value of this company to zero.

Depth of Management – Many companies are owned by entrepreneurs that essentially are a one-man-show; where the owner is involved in every aspect of the business. If something happened to the owner the future of the company is at high risk. Similarly, a potential purchaser would perceive the risk of transitioning the business from the current owner to the new owner as a significant risk and would discount the value accordingly. It is important for business owners to mitigate this risk by surrounding themselves with capable managers and then delegating authority to them. Not only will this reduce the risk and increase the valuation; it will improve the quality of life for the owner.

Competition – Every business I have ever worked with has competition. It is inevitable. It is important to evaluate the competition and determine what, if any, competitive advantage you have over the competition. If it is difficult to identify one then there is an increased risk that you will lose business to the competition over time. Another indicator that the level of competition is a significant risk is when you find yourself competing on price all of the time. Try to identify a non-price related competitive advantage and begin marketing this advantage rather than price. I have worked closely with a wholesale supplier of industrial plumbing supplies, traditionally a very competitive industry, who has differentiated themselves as the supplier who will “have the part in stock”. They have redefined their competitive proposition and now don’t have to compete as much on price. At the same time they have increased customer loyalty and reduced the overall competitive risk, resulting in increased enterprise value.

Minimizing any risk is a process of identifying the actual or perceived risk and then implementing a strategy to eliminate or mitigate that risk.

When we take on an engagement to sell a business enterprise our goal is to convince the potential purchaser that the company we represent (1) has superior earnings compared to their industry and (2) that there is minimal risk in transferring ownership. Therefore to create value, business owners should focus on maximizing earnings and minimizing as much of their business risk as possible. Businesses who accomplish these two items are frequently referred to as top performers; great places to work; well run companies and very valuable.

About Alan Austin



ALAN D. AUSTIN's diverse career has allowed him to develop a unique perspective on properly structuring M&A and financing transactions for middle market companies. Prior to joining The Capital Corporation, Alan's career included positions as a commercial lender with C & S National Bank of South Carolina; Assistant Treasurer of a Private Equity-owned healthcare products company that was an LBO spin-off from DuPont and Corporate Treasurer of the NASDAQ-listed diversified media company, Multimedia, Inc.

Alan has arranged complex syndicated loan transactions; evaluated and negotiated acquisition opportunities and participated in the sale of various companies. This diverse experience enables Alan to bring creative solutions to the unique financing and ownership transition issues facing owners of middle-market companies.

He is a graduate of Furman University and The Stonier Graduate School of Banking at the University of Delaware. Alan holds the Chartered Financial Analyst (CFA) designation, is a member of the Institute of Business Appraisers and the South Carolina Investor's Network (SCIN) and holds a private pilot certificate.