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DRIVERS TO ENHANCE THE VALUE OF YOUR COMPANY

Although it has taken a dip in the past year, merger and acquisition activity continues to be robust as compared to historic levels. As a result, private company owners should always focus on factors that will improve their business value in the event of an opportunity to sell.

Ideally, business owners and their management team should begin monitoring the value of their business at least five to seven years before considering an exit. As a result, monitoring value is something that is done in both good times and bad. The urgency to do so is greater in times like today when M&A activity is healthy.

While valuation appears to be a quantitative science about financial statements, forecasts, multiples, and rates of return, it is actually more qualitative in nature. Valuation is a prophesy of future expectations for a business. To accurately reflect those expectations, it is critically important for a business owner to identify and understand the value drivers – which are factors that increase cash flows and reduce risk – associated with the business. There are hundreds of value drivers attributable to a business, some of which are industry-specific. For brevity, we will discuss ten of the most universal factors that we consider essential to increasing cash flows and reducing risk, thereby enhancing overall company value.

Capital Access. The smaller the company, the more limited its access to debt and equity capital. The company will need to assess the kind of capital needed to achieve its goals.

Questions to ask: How is the company currently leveraged? How do bank covenant restrictions impact the business and its future plans? Do shareholders have to provide equity or personally guarantee loans? Is bringing in an outside investor and issuing preferred stock a viable option?

Customer Base. A solid and diversified customer base is essential for the ongoing viability of a business. When companies grow and prosper by providing exceptional customer service to their largest customers, dependency may increase to the point where too great a percentage of revenues are concentrated with too few customers; companies must manage the allocation of customer concentration to reduce the risk of losing a large source of revenues.

1 This article is sourced from Chapter 3 of Mellen, Chris and Evans, Frank, Valuation for M&A: Building and Measuring Private Company Value, 3rd edition (Wiley 2018).

Questions to ask: What percentage of the company's revenues do its top five customers comprise? What amount of revenue is recurring? What is the economic useful life of its customer base?

Economies of Scale. As production output increases, businesses typically achieve lower costs per unit. Whether through quantity discounts or spreading capacity costs over higher volumes, larger companies possess distinct advantages in certain operations and markets.

Questions to ask: Is the company effectively exploiting its internal economies of scale (i.e., cost savings that accrue regardless of the economic environment or industry in which it operates)? What are the company's growth opportunities such that it can realize more economies of scale? Can the company enter into a consortium, joint venture, or outsource to increase buying power and reduce expenses?

Financial Performance. Financial analysis assists in measuring trends, identifying the assets and liabilities of a company, and comparing the financial performance and condition of the company to other, similarly positioned firms. Internally prepared and compiled financial statements may hamper management's assessment of performance, causing potential buyers to question the quality of this data.

Questions to ask: How does the company compare in terms of liquidity, activity, profitability, and solvency measures? What financial controls are in place? Are the financials audited or reviewed by an outside CPA?

Human Capital. A company's employees are at the heart of an organization. Key value drivers include the knowledge, skills, experience, training, and creative abilities that employees bring to a business and the health of its company culture.

Questions to ask: What are the quality control procedures? How effective are the production/service capabilities? How is the company managed? What is the depth and breadth of management? Are there any key person dependencies in terms of technical knowledge, production skills, or customer contacts? Is there a management succession plan? What rights do individual shareholders have?

Market Environment. Each business is impacted by economic trends and developments in the industry in which it operates. Management must understand how the industry is impacted by economic factors and how the industry is structured to minimize the impact of macro trends on the business.

Questions to ask: What is the company's market share? Where is it positioned in the market? Does management have an understanding of its niche and unique offering? Does it have diverse offerings that can modulate the impact of economic swings?

Marketing Strategy and Branding. Marketing is the link between customers' needs and their response to a company's products/services. Strong branding will not only improve company sales by increasing market recognition, but it will also provide a clear direction that will improve operational efficiency when tied to the company's mission.

Questions to ask: How does the company market itself? What are its marketing and sales capabilities and shortcomings? How effective and known is its brand? What is its social media presence? How effective is its website? Is the brand tied to the company's mission statement and its strategic direction?

Product/Service Offering. Specialty companies frequently derive their strength from focusing on niche markets, but concentration may create risks from lack of diversification and over dependence on limited markets. Some specialty companies may find their largest customers adopt a policy to deal only with suppliers who offer a broad range of products, forcing them to either expand their product offerings or sell out to a larger company. Increasing diversification reduces risk which improves value.

Questions to ask: What is the company's mix of offerings? How subject is any concentrated offering to economic and industry swings? What products/services can be offered that differ from existing ones but that use similar human capital, production capability, customer base, etc. to diversify? What opportunities exist for vertical or horizontal integration?

Strategic Vision. Most companies put together a one-year budget, but few attempt to put together a business plan or long-term forecast. Valuation is all about future expectations and company management needs a strategic vision to create value. Management must take a look at all the information they've gathered from reviewing their company to divulge a strategic vision that can be passed along to the future owner, which provides additional support and assurance of continuity of, and even increase, sales.

Questions to ask: What is management's long-term outlook? When did the company last put together a formal business plan? Is the company's strategy in tune with its customers' demographics, tenure, needs, and demands?

Technology. Companies with fewer monetary resources often lack adequate research and development resources, finding it difficult to keep pace with technological changes in their markets. Such companies often face an inescapable need to incur large amounts of capital expenditures in the near future or allocate resources to a limited number of product development projects. This inevitably results in product or service obsolescence, adverse impact on future growth, and loss in market share. In the meantime, larger companies are in a better position to demonstrate technological expertise by developing products that address emerging customer needs such that customers may choose their state-of-the-art products, despite the availability of lower-cost, lower-performance technology.

Questions to ask: How much resources does the company allocate to R&D? Is their use of technology up to date? Are there impending technological changes that could negatively impact the company's product/service offering?

CONCLUSION

Ongoing assessment of a company's value drivers is integral to its success. The valuation process involves both a quantitative and a qualitative assessment of a company that should be part of any business owner's standard operating procedure as a useful and important business management exercise. A valuation assessment can provide the business owner with meaningful and oftentimes actionable information that highlights the real intrinsic value of the firm, and ultimately maximize returns.