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*Advice
for business
owners,
investors and
service providers
on how to build
value and wealth
through
investment in
closely held
companies.*



The Business Value Manager

Can You Double Your Company's Value? Here's a Blue Print for How

Critical Planning Steps for Private Company Owners

If you want to cash out of your private company in, say, five years, could you afford to do so? That is, would the income from investing the net after tax proceeds from the sale of your company enable you to enjoy your current standard of living? And what immediate steps can you take to double your company's stock value? The following is a four-step, annual planning process, with an illustration, of how to double your private company wealth.

Step One—Determine Your Value

This isn't the price you want for your company, but what the whole company, and each shareholder's stock in it, is really worth. This is the baseline to begin your process of value management.

Step Two—Focus of Your Value and Risk Drivers

To build value, you must understand what makes your company's value increase or decrease, and the following are the key metrics you must manage.

Investment—This is the cash your company has tied up in current and fixed assets and intellectual capital. While you need these assets to make money, you should keep this investment to the minimum required. Most company's returns are hampered by mismanagement of, and excess investment in, accounts receivable,

inventory or fixed assets. To improve your performance and free up cash unnecessarily tied up in your company, reduce your receivable collection period, increase your inventory turnover and improve your fixed asset efficiency to at least equal your industry's standards.

For example, \$1 million of excess cash liquidated from these assets and invested at 8% would generate an annual income of \$80,000, while not diminishing your company's value. *Are excess assets draining your cash flow and return on investment?*

Return—This is the net cash flow your company generates, and it is determined by your sales volume, profit margins and asset reinvestment requirements. To improve these, examine your best options and strategies to raise revenues with higher unit sales volume, new product or service offerings or better pricing. Next, look at where you can reduce expenses to improve profit margins. Then, seek ways to reduce or eliminate your need to further invest in receivables, inventory or fixed assets. Success in each of these areas will improve your net cash flow and value. For example, an improved annual net cash flow of \$100,000 generates an increased company value of \$1 million when capitalized at 10%. *How can you*

(Continued on page 2)

(Continued from page 1)

boost your revenues, improve your margins or reduce your assets to build value?

Risk—This reflects your company's likelihood or probability of success, and this factor greatly affects your value. Lower risk—a higher probability of achieving your income and cash flows—increases value, and higher risk decreases value. Most often, risk is heavily influenced by these key factors:

- ⇒ **Management**—Good companies have broad, deep talent in critical functions, and key personnel gaps drive value down. Identify each major function your company performs, and then assess the quality and depth of your management in each of these areas. Then, assess your management development program as well as your management succession plans. Finally, candidly consider, *can your team lead the company without you?*
- ⇒ **Customers**—More customers, rather than fewer, who have a greater, rather than lesser, reliance on your company increases value. Strong companies have developed a broad customer base to avoid excess reliance on specific customers. *How diversified and loyal are your customers, and what unique value do you deliver to keep them?*
- ⇒ **Intellectual Capital**—This is what your company knows or does that is valuable to your customers and hard for

your competitors to replicate. Processes, formulas, brands, knowledge, quality and contacts are the barriers that form your competitive advantage. Stronger companies continually seek improvements in quality, efficiency, technology or customer service to improve their edge in the market. *What does your company have that gives it an advantage over your competitors. How long will these barriers continue to protect you, and what can you do to strengthen them?*

- ⇒ **Products/Services**—The strength of many middle market companies is their singular focus on a narrow range of products or services, but this focus can also create heavy concentration risk. Stronger companies build broader product or service lines to increase customers' reliance and raise their cost to switch suppliers. They also continually develop value added services to improve profit margins and create differentiation from competitors. *Does your reliance on a few products or customers make you highly vulnerable to change?*
- ⇒ **Industry and Markets**—Size counts. Larger markets and growth opportunities generate higher values than limited markets or declining industries. Stronger companies can present and defend a convincing long-term growth strategy for their market. *What compound annual growth rate can your company expect for the long-term, and what can you do to improve these prospects?*

Charlie's Entrepreneurs' Value Building Strategy

Charlie currently makes a salary and benefits of \$300,000 a year from his company that generates annual revenues of \$12 million, with earnings before interest, taxes, depreciation and amortization (EBITDA), with appropriate add-backs, of \$1.2 million. He wants to exit the company in about 5 years—no more than 7—and would like to at least maintain his current \$300,000 standard of living. Can he do it?

As the example that follows illustrates, sale of his company now, at approximately 5 times his EBITDA, nets him only \$2.4 million, which invested at 5%, generates \$120,000 of annual income, which is only 40% of his current income.

How can he maintain, or at least get much closer, to his current standard of living, through a sale of his company? The key is to build his company's value as this article explains. If over the next 5 years, Charlie can drive up his revenues and improve his margins and asset efficiency, increase the company's size and improve its strengths, while paying down some of its debt, his prospects for financial security are greatly enhanced. As the numbers on page 3 indicate, his equity in the company can more than double, and his post-sale after-tax return can be 2.5 times higher and increase to his current level of \$300,000 by successfully implementing these plans.

Entrepreneurs like Charlie can build private company value, but their likelihood of success is dramatically higher with a carefully drafted plan that focuses on value and is annually reviewed and adjusted to meet continually changing business circumstances.

Charlie Entrepreneur Value Enhancement Illustration

Period	EBITDA	Valuation Multiple ⁽¹⁾	Invested Capital Value	Less: Interest Bearing Debt	Total Equity Value	Net ⁽²⁾ After Tax Proceeds
Latest Period	\$1.2 M	x 5 =	\$6.0	- \$2.0 M =	\$4.0 M	\$2.4 M
After Improvements	\$1.8 M	x 6 =	\$10.8M	- \$.8 M =	\$10.0M	\$6.0 M
⁽¹⁾ Value would normally be determined in a more precise manner than a simplistic multiple.				<i>Increase in Equity Value</i>		\$3.6 M
⁽²⁾ Net proceeds from sale after paying taxes on gain and transaction costs.				<i>Rate of Return</i>		X 5 %
				<i>Increase in Investment Income</i>		\$180,000

(Continued from page 2)

Step Three—Create a Strategy to Build Value

With proper execution of Step Two, you should now clearly see your company’s competitive advantages and disadvantages. The next step is to design strategies to capitalize on your strengths and shore up weaknesses. This plan should include clearly measurable operating and financial objectives with deadlines for achievement. Therefore, the effect on net cash flow of every strategic initiative must be quantified in a forecast and budget. The effect of each proposed change on the firm’s risk profile and value must also be computed.

You must also confirm with each shareholder that this plan and timetable meets their investment objectives. Because of differences in age, wealth, liquidity and risk tolerance, shareholders’ goals for their private company investment may vary. Such differences make no investor’s preferences wrong, but they may make the company’s resulting strategy inappropriate for that investor’s goals. When different shareholder visions or goals exist, your strategy may have to be adjusted or those shareholders may have to sell their stock and seek alternative investments.

Step Four—Annually Review, Adjust and Reassess

Review your key performance metrics of investment, return and risk and their resulting affect on the company’s actual value versus your forecast and beginning of year value.

Adjust your strategic plan based on your performance to date, your new competitive climate and management’s capabilities and performance.

Reassess the likelihood of achieving your financial goals and your timetable and whether there needs to be any changes in shareholders’ goals and schedules. Finally, each shareholder should candidly determine whether this company represents a sound investment for them on a risk-adjusted basis. Your private company investment, like any other you own, should be sold when it no longer meets your investment objectives.

Conclusion

Can you afford to immediately begin this value building process? The real question is—can you afford **not** to do this? And when is a better time than now to create a clear blueprint for doubling your private company wealth? Call us to get you started on the right track.

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In this issue . . .

- ⇒ Can You Double Your Company's Value?
Critical Planning Steps to Build, Protect and Harvest Your Private Company Wealth.

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