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# The Business Value Manager

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

## Is Your Company Building Wealth? **12** Critical Value Metrics to Constantly Monitor

Is your company creating value? That is, is it generating adequate returns on the capital you have in it, considering its level of risk? Theoretically, if you create value during a year, then potential buyers would be willing to pay more for your company at the end of the year than they would at the beginning. Since your other investments provide returns, either in the annual dividends they generate or through capital appreciation, you should demand the same returns from your private business.

To manage value, owners must recognize the factors that cause value to increase or decrease. These are the competitive advantages - the risk and value drivers - that affect the company's performance everyday. The following are twelve critical value metrics that business owners should constantly monitor.

### **1** Revenues

In general, your sales should be growing, at least as fast as the average growth rate of your industry. If not, you must examine why sales are lagging behind. Look further at individual product or service unit volumes, pricing, customers and competitors. Determine where sales growth is coming from and where the best growth opportunities lie. Next, identify where the best pricing opportunities are concentrated

and where the competition is strongest and weakest. Finally, assess the performance of your marketing and sales team and your strategy that yielded these results.

### **2** Customers

Critically evaluate your customer base in terms of volume, margins, growth potential, servicing requirements, and their financial health and the health of their industry. Customer concentrations often create excessive dependence and should be avoided. Examine why customers choose to do business with you as well as why they go elsewhere. From this, identify the critical strategic advantages over competitors that you possess and the weaknesses that hamper your performance.

### **3** Barriers To Entry

What does your company do that is particularly difficult to duplicate? Are you the low price or high quality leader? Do you have the best brand name, distribution system, or most efficient production? Identify what you do best—especially things competitors would find hard to replicate—and protect these barriers and attempt to extend them. Similarly, look

*"Identify what you do best - especially things competitors would find hard to replicate - and protect and extend these barriers."*

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### KNOW WHEN TO GET OUT

" The life expectancy of many smaller companies is growing shorter as today's fast-moving economy produces opportunities and then almost immediately begins destroying them.

That means increasingly entrepreneurs need to quickly enter a market, exploit it as fully as possible, and then be prepared to get out before profit margins become too narrow to support the business.

What's driving the trend? The strong downward pressure on prices that global and technological competition brings is collapsing profit margins across many industries, leaving fewer crumbs for small companies to capture."

- from the article "*Pressure Increases to Make the Money and Run*", Wall Street Journal, Jan. 14, 2003

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at what you do that everyone else can do and search for ways to differentiate. Otherwise, your products or services drift toward being commodities—with low prices and margins.

#### 4 Excess Capacity

Whenever possible, avoid selling products and services in markets where excess capacity exists. The excess drives prices and margins down and kills return on investment. It can exist for years in industries, preventing everyone from making money.

#### 5 Breadth of Products

Many successful companies have made their name through excelling at production of a specific product or service. Recognize, however, that this narrow focus concentrates your risk and may make you more vulnerable to technological changes or consolidated buying patterns. Narrowly-focused companies must pay extra attention to industry trends and the strategies of their more diversified competitors to avoid being squeezed out of markets. Larger competitors often "bundle" products to achieve a predatory

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price against a competitor that sells only that one product.

#### 6 Distribution

How does your product or service get to your customer? Is it through direct contact where you can continually monitor customer needs and level of satisfaction? Or is it indirect through referral sources or a system of broker dealers? Larger size often creates enhanced market presence and contact with customers, which brings with it the ability to understand their needs and promote your benefits. Where distribution weaknesses or disadvantages exist, alternative networks must be created to build and nurture customer loyalty and market knowledge.

#### 7 Competitors

Candidly assess how your company compares to your competition in terms of critical measures such as product quality, pricing, service, and reputation. Identify best practices, your company's strengths and weaknesses and the strategic advantages and disadvantages that allow you to compete and grow. This assessment should then drive your strategy.

#### 8 Management

Management depth and breadth is essential for the long term continuity and success of a business. Examine your core functional areas—usually sales, marketing, production, distribution, finance and information systems. Does proper leadership, experience, vision, and creativity exist in each area? If necessary, are second or third level managers being groomed to handle the company's growth? Particularly critical in middle market companies is executive leadership who possess the vision and strategy to provide the company with direction and growth. Too often in the middle market, companies initially prosper as a result of this capability, but then outgrow the initial executive capacity. Frequently, executive positions are passed onto successors—often children— who lack the requisite skills or drive. As a company's needs change, its management capabilities must change as well.

#### 9 Asset Efficiency

Look at your balance sheet and compare the growth in your

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company's total assets over the last five years to the growth in your sales. Then make a similar comparison to sales growth for each of your major assets—typically receivables, inventory and fixed assets (before depreciation.) In the middle market, companies frequently over invest in assets, which consumes their cash and drags down their return on investment. Most companies have excess cash tied up inefficiently in slow paying receivables (which may become uncollectable), excess inventory (which may be becoming obsolete or unmarketable), or under utilized plant and equipment. A major contribution of an effective CFO to a company's performance is continually minimizing this asset base to maximize cash flow and efficiency in asset utilization. Remember, under utilized assets could be converted to cash and invested elsewhere to generate positive returns.

*“While firms should maintain additional debt capacity should funding unexpectedly be needed, they should recognize the financial benefits of borrowing at moderate levels.”*

## **10 Operating Efficiency**

Many of the costs that a typical company incurs are fixed and provide a business with a specified level of operating capacity. A key goal that contributes to optimum efficiency and profitability is to produce at full capacity to achieve the lowest fixed cost per unit by spreading the fixed capacity cost over the maximum possible volume. Lower volume levels create higher fixed costs per unit and resulting lower margins. In the middle market, companies frequently must improve their sales and marketing capability to increase sales to achieve maximum operating efficiency.

## **11 Benefits of Debt**

Because the interest cost of debt is tax deductible, mortgages, bonds and notes tend to be a less expensive source of capital than equity. Firms looking to maximize value take advantage of low cost debt capital up to a reasonable limit. This limit is set by the company's collateral base and the cash flow it generates to service the debt. While firms should maintain additional debt capacity should funding unexpectedly be needed, they should recognize the financial benefits of borrowing at moderate levels.

## **12 Profit Margins and Net Cash Flow**

Profit margins are affected by pricing, volume and expense levels. The gross margin is the profit after direct production costs including materials, labor and overhead, and operating profit is the margin after the operating expenses are subtracted from the gross profit. Gross profit and operating income percentages should regularly be monitored to identify the factors that lead to changes. Margin data should also be analyzed by products, markets, customers and competitors to determine the direction of the business to maximize profits.

The cash flow reinvested for working capital and fixed assets also affects investor returns. By maintaining only the most efficient asset levels, more cash is available for payment to shareholders as a return on their investment.

### **Conclusion**

Owners and executives of middle market companies should manage their business as an investment to maximize value and wealth. This management should include a constant attention to value and the factors that most affect it. A continual monitoring of the metrics described above can produce significant performance improvement - and an increase in the value of the shareholders' investment.

### **FIRST STEPS**

To manage your business as an investment and take control of your life:

- Retain qualified valuation advisors to lead the process.
- Identify and prioritize your personal and financial goals.
- Quantify
  - Your company's return
  - Your company's risk
  - Your company's worth
  - Your company's return on investment

### **RESULT:**

Armed with the information, you can devise the best strategy to achieve your business, personal and financial goals.

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