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THE CEO'S GUIDE TO

MAXIMIZING COMPANY VALUATION IN 2016

AXIAL FORUM
THE SELLER SERIES

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You’ve worked hard to build your business.

Determining what your business is worth, to whom, and why is one of the most challenging parts of any M&A transaction. Working to increase this valuation should be top of mind for any owner preparing for a sale or capital raise.

The first step is to take a step back and evaluate your company from an objective standpoint.

Working with an investment banker, M&A advisor, and/or valuation expert can help you manage your expectations — while also identifying realistic ways to enhance your company’s value in the eyes of potential buyers or financial sponsors. In this ebook, you’ll learn:

→ How to clean up your cash flow before a transaction

→ How to address often overlooked value maximizers

→ How to increase your financial and strategic value

Getting Started

Lindsay Burton, founder and managing principal of Kayo Advisory, says business owners sometimes think their company's worth should be directly correlated with their investment in the company thus far.

"It doesn't matter how much money you've put into the business, or how much you paid for it. It doesn't matter if you got an offer for the business five years ago at X amount. You have to reevaluate valuation at every inflection point," says Burton. "From a buyer's perspective, they're looking at factors like what the business is generating on an EBITDA basis today and what they can do to improve or create synergies going forward."

Hiring a trusted advisor is a key first step to maximizing your company's valuation. Says Richard E. Schmitt, president of Gordon Brothers-AccuVal, a leading business valuation firm, "Having a team of people who you as a seller can talk to that you trust as unbiased and independent is extremely helpful in the process."

An advisor can help you evaluate your current company, articulate your transaction goals both externally and internally, and create a strategy to improve your company valuation in your desired timeline.

Schmitt says it's crucial to understand exactly what factors drive the marketability and value of your business. "Here's where a value advisor can help you in terms of making sure you've looked carefully at the earnings of your business." Are your earnings durable? For example, if your business had had a lot of large one-time contracts in the past few years that are unlikely to repeat in the future, says Schmitt, "there might be a misalignment in how you and the marketplace value your business." An advisor can help you evaluate "spikes in earnings" vs. the "portion of your earnings that repeat year after year and that will be looked at by the market as durable."

HOW TO VALUE YOUR COMPANY

There are multiple ways to arrive at your company valuation. For a quick primer, read The Guide to Private Company Valuation and download our free Discounted Cash Flow Excel template.

Sean Hutchinson, founder and CEO of Strategic Value Advisors, says advisors "are there to act as a sherpa on this mountain climb. We help explain the relationships between information, decisions, and value."

An advisor can also help owners successfully manage the dual roles that come with running a business while preparing for a transaction. "This process is extremely time consuming," says Schmitt. "It takes quite an effort to bring the process to the finish line."

STRATEGIC VALUE VS. FINANCIAL VALUE

There are two types of business value: strategic and financial.

Unlike a financial valuation, which is concerned with the historical performance of the company, strategic valuation is all about "unlocking future potential," says Eric Meerschaert of Chicago M&A Advisors.

How can you increase your strategic valuation?

1. Assess your influence value.
Private companies under $100 million won't ever have the sort of brand equity a company like Apple or Nike holds in the market. But, says Meerschaert, they can garner a certain "influence value," which exists on a smaller scale but is just as crucial to the business's success.

To determine your company's influence value, ask questions like:

- → What do influencers in your industry say or know about your business?
- → What's the value of your solution relative to competitors?
- → How active are you in driving dialogue in your industry?

2. Build provable predictability into your revenue generation engine.
Don't just shore up sales — shore up your marketing and sales pipeline. Measure and track the strength of your customer relationships. Meerschaert says the key is to show potential buyers or sponsors not only that you have the capability to meet or exceed your sales targets not just this year, but for the next five years.

3. Ensure the business runs smoothly without you.
The business should be a well-oiled machine — one that doesn't require you to flip any switches. Make sure you have transitioned ownership of critical relationships to those who will stay after the transition.

Create a Plan

"Planning is a natural place to begin," says Hutchinson. Some business owners may have been heads-down on their businesses for years, without a clearly articulated plan. "A lot of risk naturally accumulates in businesses as they get bigger and more complex. Business owners often don't have a roadmap."

Every business plan should articulate a clear strategy for repeatable growth.

When creating a business plan, "understand your areas for growth," says Schmitt. "The more articulately you can convey to buyers how bright the future is with respect to growth and expansion, the better off you'll be during the negotiation process."

Eric Meerschaert, managing director at Chicago M&A Advisors, emphasizes that every business plan should articulate "a clear strategy for repeatable growth." He points to a past client whose business had a very good year, growing at twice the industry average. "When the owner went to sell, the first question was, 'What are you going to do next year to get that same growth?'" As an owner, don't necessarily expect buyers to suss this information out on their own. "You have to communicate an achievable strategy that shows why growth is sustainable," says Meerschaert.

THE IMPORTANCE OF COMMITMENT

As a business owner, you may be tempted to casually evaluate the market for your business by entertaining conversations with potential strategic or financial acquirers. But what may seem like a low-stakes meeting could be detrimental to your business's ultimate prospects.

Says Schmitt, "My first advice is to make sure that you as an owner of the business are committed to the process. Testing the waters can do damage to the marketability of your business."

There might be a gap between your valuation expectations and the would-be buyer's, or the buyer might perceive that you aren't approaching the process in a sophisticated manner. If a conversation ends, it will be difficult to get that party to come back and take another look at your business once you've gotten serious.

Wait until you've engaged an advisor to discuss potential growth or exit opportunities. You should have a clear idea of what a fair offer for your business is — and "be mentally prepared to commit" if someone puts it on the table, says Schmitt.

Clean House

"Valuation comes down to fundamentals," says Kayo Advisory's Burton. "At the end of the day it's all about cash flow and consistency and margins and momentum."

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"Most of our clients have excess working capital that's just sitting there," says Hutchinson. This uninvested capital is often "decreasing in value against inflation," so the key is to find valuable parts of the business to invest it in.

At the core, Hutchinson says, there are three things that can help create value in a business.

1. **Increase earnings.** Increase sales and reduce cost of goods and overhead.
2. **Reduce risk.** There are dozens of ways to reduce risk in a business, from decreasing customer concentration to succession planning to creating recurring revenue.
3. **Position the company appropriately for its value in the marketplace.** Aligning expectations will reduce the chance of deals falling apart in later stages.

It's important to "take a hard look at your operations" before bringing your business to market, says Schmitt. "You may have been an owner for many years and there may be places where excess expenses have crept in or unproductivity has occurred. You have the ability to identify and execute changes before a buyer comes in." Otherwise, a buyer will find these inefficiencies during due diligence, and will offer you less for your company as a result.

Schmitt gives the example of a company with five locations. Four of the five are earning money and doing well, but the fifth location isn't performing at the same level. "It may make sense to sell and close that location to convert the underperforming asset into true cash, and increase the value of the business through the process," says Schmitt. Another example might be a manufacturing company getting rid of excess inventory.

Schmitt also cautions owners to look at "hidden liabilities and contingencies" that may exist out there. Can sold inventory be returned by the customer? Do contracts have holdback clauses? Buyers will look at your balance sheet and consider the receivables and collectability of your accounts. Working with an accountant can help make sure you know how to frame these liabilities in the most effective way possible.

4 WAYS TO IMPROVE CASH FLOW

1. Reduce overhead.

One great place to start is to save money with your vendors. Do a quick inventory of what services you are paying for. Are there any services you are not using? Do you have any equipment that is lying idle? If so, trim the fat and lower your costs.

Once you have eliminated any services you don't use, take a look at the ones you do. Are you receiving all agreed-upon discounts? After looking into this detail, consider negotiating with service providers to secure a better deal.

Pursuing some type of supplier financing agreement may be an option for businesses who want to lock in competitive rates and quicken the production to sale cycle. Exploring negotiation around trade credits might also be an opportunity. Receiving a modest discount by paying bills early can produce great results. For example, paying all bills due in 30 days within 15 days might result in a 1 percent discount.

2. Do a customer audit.

A late paying customer isn't necessarily a bad customer. Many businesses are too quick to write-off customer billings. Instead, explore new payment plan options with these select customers and make a focused effort on collecting old billings even if it means compromise or turning to a collections agency.

A FEED-STARVE ANALYSIS

When making operational improvements, Hutchinson says that owners need to think about how they're using their capital. "It's a feed starve analysis," he explains. "We encourage clients to think about their business as a mosaic of different economic activities. If there are 20 tiles in the mosaic, some are more important and others are less important. I can wager based on experience that a significant majority of those things are probably value neutral or negative, while the others are producing value. The question for the owner is: do you know which are which?"

Then, it comes down to making the decision to feed high-growth activities and starving things that aren't producing returns. "We do an analysis of how much is being invested on a total capital basis," says Hutchinson, and reassign capital where necessary into higher yield activities.

Make an effort to improve customer concentration as well. "If a significant amount of revenues is concentrated in a few customers, or if critical supply chain raw materials are concentrated in one vendor, the buyer's perception of risk is elevated substantially," notes Gary Miller of SDR Ventures.

"Regardless of the longstanding business relationship that the seller may have with any customer or vendor, buyers have to factor in the potential loss of that customer or supplier. Ultimately, mapping out the consequences of that loss could cause the buyer to walk away from the deal," says Mller.

3. Reduce inventory levels.

For businesses with physical products, inventory and turnover is always one area to look for potential improvement. As long as it sells easily, inventory is a quick source of revenue. However, if it stays on shelves, inventory does little for your company. To maximize cash flow, consider stocking only items that will sell quickly.

If an item has been lingering on a shelf for too long, think about lowering its price. Even though the resulting marginal profit will be lower, the money you receive can be invested into inventory that will move quickly. Another technique to help ensure items don't stay on shelves too long is farming out requests for custom inventory to suppliers that can distribute directly to customers.

4. Pursue growth strategies.

Many businesses spend years pursuing aggressive growth strategies even if the end goal is to sell, with the idea of a better outcome for the business and better sale price for the owner in mind. This might mean taking on growth capital, exploring expansion into new geographical markets, pursuing M&A targets of smaller, peer or competitive companies in your industry, consider partnerships, horizontal or vertical integration strategies, or other more organic growth mechanisms.

Consider Your Role

Make sure your business's value isn't entirely locked up in you as the owner.

It's important to make sure that the business's value isn't entirely locked up in you as the owner. Says Meerschaert, "many owners have been so good at being the strategic dealmaker that they end up owning the top tier of customers all by themselves. That's a clear mistake. It may be the reason you've been successful so far — but it also means you can't wake up and sell your business in six months. First, you'll have to transition those relationships to someone else."

Otherwise, such a setup will have practical consequences, says Meerschaert. You might have a profitable business, but when a buyer looks up close and realizes you own 80 percent of sales numbers single-handedly, their offer will reflect it. "They may pay very little upfront cash and instead pay out over a few years time as the owner teaches them what he or she knows" about the business.

GET YOUR BENCH IN ORDER

Whether you like it or not, much of the value of your company lies in your management team. "The right management team positioned in the right way" is a key driver of your valuation, says Meerschaert. He recalls a previous role at a company that paid 40x EBITDA to buy a software company. A big part of the reason was "we saw enormous value in the sales and marketing executives driving the company."

When positioning the business for sale, consider "what the likelihood is that they will continue to stay," says Schmitt. It can be problematic if all the talent is concentrated in the executive team, especially if their commitment is uncertain. "Make sure you have your bench in order when looking to sell," says Schmitt. Potential buyers or investors will ask questions about your succession plan — so have one. If you're planning to sell, will you stay on after the acquisition? For how long? What about key employees?

QUICK TIP: FIND A NICHE

"A company is not going to have brand value unless they have a niche," says Hutchinson. "Find a white space in the market that you can claim and fill out before anyone else does."

This is a high-level endeavor, he says, but it doesn't mean that owners need to change their business model. Instead, think about "what you do well already. Is there a space that has not been claimed by anyone else?"

MANAGE INFORMATION

"You have to assess the risks associated with employees knowing that you're going to sell the business," says Schmitt. Ask yourself how you think your employees will react, and if they will want to leave now before the business is transferred.

Hold early discussions away from the business.

When selling his own company, Schmitt says he "brought people in through a phased process in a staged environment. Early discussions were held away from the business, in an outside location and with a strict NDA in place. Once it appeared that we had a meeting of the minds from a theoretical perspective, the trusted personnel were brought in. But we still held meetings away from the business."

"You don't want to parade a lot of suits through the company, or else everybody starts to create their own truth," cautions Schmitt. Rumors can cause harm to the company culture and to the sale process.

Consider Culture

Advisors and investors talk about a lot of strategies when it comes to value creation. "One thing I have never seen on the list is employee engagement," says Strategic Value Advisors' Hutchinson.

He gives the example of a $50 million business with 200 employees. Of that team, there might be a 10 person management team. Those 10 people can institute all the best practices out there, but "if you don't communicate and engage with employees so they think and act like owners," how can the company possibly sustain the improvements?

"They can't," says Hutchinson. The best programs "will never stick because the culture has not been adequately prepared to actually adopt the behaviors and best practices that go along with value creation."

Hutchinson theorizes that part of the reason employee engagement isn't a part of the conversation is because "we don't like to manage people." That includes owners, management teams, advisors, and investors. "It's a painful territory, so we avoid it."

Hutchinson points to a 2011 Gallup poll that found that 71% of American workers are either "actively disengaged" or "not engaged" in their work.

"Everybody will say people are the heart of the company; people are the best asset. But if people aren't engaged, if they are disconnected from the mission and purpose of the company, and they don't understand why their contributions are valuable, you've got a huge problem," says Hutchinson. "I wouldn't invest in that kind of company."

An engaged company, on the other hand, is an inherently attractive investment.

"You can tell when ideas are flowing from employees and not just the management team and the owner. People take responsibility for their work, they understand metrics and often propose new ways of measuring performance."

A team with low turnover, high productivity, and a sense of ownership also makes the success of a business easier to predict. "Businesses where employees are engaged are disciplined businesses, and disciplined businesses are simply worth more."

Plus, "Employee engagement will make succession planning far easier," says Hutchinson. "Folks who are engaged usually step up to the next level" — providing multiple choices within the organization for people to fill key management roles.

STOP PLANNING, START PITCHING

Hutchinson says there are many ways to encourage employees to think and act like owners.

One idea he's implemented with clients came to him while watching an episode of Shark Tank. While watching a contestant pitch a business idea, he thought — what if we replace the traditional business planning session with a series of pitches?

Business plans are problematic — they often become too cumbersome and difficult to incorporate into the daily routines of the business. Jokes Hutchinson, the typical plan sits on the corner of a conference room table "growing, until finally everyone puts a plant in front of it and tries to forget it." (He points to the **One Page Business Plan** as one helpful solution for management teams who find their plans out of sync with reality.)

What if you turned your planning process into an episode of Shark Tank?

In Hutchinson's model, employees pitch their plans directly to management and investors, shifting away from "passive planning done in the echo chamber of a board room" to an active, exciting process that requires employees to take charge and really wrestle with the value of their ideas alongside key stakeholders.

He says the new idea has made "engagement around planning skyrocket" at companies where it's been implemented. And the end result is a business plan that is much more tied to concrete goals and the capabilities of the team.

VALUE CREATION AS AN END GOAL

"Some people believe that an owner's motivation for engaging in value creation is to ultimately sell the company," says Hutchinson. "For some owners, that may be true." But he says creating value can have much larger repercussions. An engaged workforce is good for business, it's good for transaction value, and it's good for the well-being, happiness, and satisfaction of the employees, the management team, the owner, and the customers alike. "When we create value, we create wealth and opportunity for everyone in the company."

How Long Will It Take?

"If your recent earnings have suffered, a prep process might consist of two whole years before you market the business. If you've run a tight ship, if the company is performing to the extent it should be, the process can take six to nine months from start to finish," says Schmitt.

Strategic Value Advisors works on a 18-24 month timeline, with a highly structured program that is customized to each client. "The conventional wisdom is 3-5 years to exit," says Hutchinson, but he believes that owners don't need to wait that long.

DERISKING YOUR POSITION

"Creating readiness" is one of the most important aspects of working with an advisor, says Hutchinson. It's only natural that an owner wants to exit within his or her desired timeline and at a desired value. "You might get one but you very rarely get both," says Hutchinson.

Hutchinson points to data from Pepperdine University that indicates that 80 of every 100 businesses will eventually liquidate instead of transition. "Out of the remaining 20, 8 will never make it past the first level of due diligence — only 12 will get something out of the process." An advisor's role is to help the owner work to progressively derisk his or her equity position. "We want the owner to be in that 12, or hopefully as advisors we want to be able to help increase that number."

Hutchinson considers a hypothetical business looking to sell. "Early on in the process, the owner might sell 5 percent of the company to the management. This derisks the owner's position and gets the management team aligned as equity partners. Then, the owner might create some type of additional stock ownership program and allocate 20 percent of the company that way. There could be a recapitalization along the way to help manage growth."

TIMING THE MARKET

Schmitt says that most private business owners tend to be pretty certain about their decision to sell — "more often than not the sale occurs at a point in time where the existing owner has had enough and is ready to retire." (This can be different with private equity-backed businesses, which are by nature highly strategic with their sale timelines and may be constrained by charters requiring them to return money to investors after a certain number of years.)

The economy can be a reality you can't overcome.

But when considering a sale or capital raise, economic cycles and industry factors are of course a consideration. Chicago M&A's Meerschaert notes "the economy can be a reality you can't overcome." Today (March 2016), he says, "there's still money in the marketplace and an awful lot of interest in valuable assets. People who don't capitalize in this market may find a much tighter market in the next couple years. I wouldn't advise someone to wait four years because if they wait four they might have to wait six or seven."

"There will always be certain businesses that know when the economic cycle isn't right for sale," says Schmitt. "People in the oil and gas and steel industry know that now is not the time to sell" voluntarily. But a sale might be inevitable for owners who need to come up with more equity to satisfy lending institutions "asking them to sell or put more money in because the asset value has deteriorated."

Says Schmitt, "In those situations, you can still make the best of a bad situation" and work to maximize your company's value as much as possible.

Conclusion

“Selling a business is a very emotional decision,” says Meerschaert. It’s crucial to consider what’s right not just for the business, but for the employees, you as the owner, and your family. Ideally, “the decision can be one that is not just financially rewarding but also personally rewarding.”

To the extent possible, try to “take your emotions out of valuation,” says Burton. “When you go to sell your business, it can be hard to hear critical feedback or learn that someone else doesn’t place the same worth on your business that you do, that they’re not trading at the multiples you think your business is worth.”

Surrounding yourself with trusted advisors can help you create and execute a plan to maximize your valuation in the context of these exogenous factors. Sometimes, emotions and personal expectations may cause you to “postpone a decision that makes sense from an objective standpoint.” As you work to prepare your business for a sale or capital raise, advisors can also help you evaluate offers with an open mind, and ensure that you make a smart business decision for the right reasons.