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The Value Of A Company, Whether Growing, Selling Or Financing, Is Eventually Based On Future Cash Flow, Adjusted For The Likelihood Of It Occurring

Written By Kenneth H. Marks 2/9/2010 6:20:00 PM - Article #3043

Only a year or two ago an emerging growth or middle-market company (revenues from a few million to several hundred million dollars) had a good chance of being sold if it was reasonably well run. With private equity flowing, plenty of debt and liquidity, and strategic buyers growing valuations were up and it was a seller’s market. “A” companies, those that are the leaders in their market segments and high performing, will likely find buyers at traditional valuations and premiums. At the other end of the spectrum, the “C” and “D” players are trying to survive or being liquidated.

So what about the “Bs”? The large majority of emerging growth and middle-market companies fit the “B” profile and they are stuck, at least in terms of creating shareholder liquidity or selling. At a minimum “B” companies are being transacted at significantly reduced multiples. You can think of this as a bar bell effect, where the companies on the right side are sellable and those on the left are being liquidated…those in the middle i.e. the “Bs” are not moving. The quandary for “B” owners and managers needing or wanting liquidity is at best a company that will sell at much less than expected or at worst there is no buyer or financing.

The value of a company, whether growing, selling or financing, is eventually based on future cash flow, adjusted for the likelihood of it occurring. So the actions you take to position a company for sale are nearly the same as those to grow it or obtain new capital. In generic terms, you can increase the value of the business by increasing cash flow while using the same or less capital. If you cannot increase the cash flow, focus on reducing the invested capital. If you cannot significantly impact the cash flow or invested capital, you may be able to reduce the risk of the capital invested - this will also increase the value.

In practical terms, focus on the fundamentals and their alignment, being able to answer the tough questions in terms that a sophisticated third party buyer or investor will find attractive. For many management teams, this begins with a shift in mindset from “how we have done things in the past” to “how do things need to be in a future state to generate the expected cash flow and results”.

1. Strategy

Selling a company for a premium requires selling the vision and future, using the past to evidence management’s credibility and the business’ ability to perform. It requires articulating in strategic and financial terms the outlook and expected performance along with strategic initiatives. A buyer’s or investor’s evaluation of the business begins with understanding the strategy. In simple terms, management needs to understand its industry and be able to articulate its relative position and performance in the market compared to competition. Then be able to articulate a strategy to improve its position over time. Common questions include:

- Where does the company add value in the supply chain of its customers and suppliers?

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- What activities are profitable for the business and why continue those that are not?
- What is the company’s “secret sauce” or unique or difficult to duplicate aspects of the business?

2. Management
A buyer or investor is going to look at your management team in terms of what skills and experiences are required to build the business moving forward. The team that got you through the earlier stages of the business may not be the team to get you through the next. We recommend assessing your team for industry and functional knowledge relevant to the stage and expected plans of the business moving forward. Where it makes sense, implement professional development plans and train members of the team. In other cases, it may be require hiring new talent to round-out the group. Having a proven team that can operate without significant dependence on any one person, reduces the risk of execution and dependence on the owner / founder.

3. Scalable Infrastructure
Another issue that commonly surfaces in evaluating a company’s ability to execute on its forecast is the capability of its systems and processes to scale as the business does. Management can reduce execution risk and enhance the value of the business by having infrastructure appropriate to the go-forward plans. Typical areas for improvement include the selling process and strategy, information systems and metrics, financial controls and reporting, and planning and decision making processes.

4. Operating Decisions
Why wait to sell or raise capital to implement the operating changes that a buyer or investor will likely pursue? Example decisions or issues to address in advance of a transaction:

- Customer selection - do you have customers that value your product or service, and that are willing to pay for your value-add? Maybe your company needs to trim its customer base and focus on customers that will help you get to the next level? On the other hand, does your company have a high concentration of revenue with any single customer? If so, how are you mitigating that risk?
- Product or service pricing - are you pricing your product or service relative to the quality and value-add in the market. Is there an opportunity to increase prices and margins?
- Is your supply chain and inventory managed to optimize the cash cycle vs. customer satisfaction? How can you reduce the invested working capital AND increase quality and availability of products or services?
- Is your house in-order - do you have reviewed or audited financial statements and are your records organized and complete? These will increase credibility and speed due-diligence.

By addressing key gaps and pursuing operating opportunities for improvement, management can significantly impact value and likely get paid for it in the transition or sale process.

5. Capital Formation
If the company is considering a capital raise, proactively raising funds before you need them can put the company in the driver’s seat and control of its options… raise capital when you can, not when you need it. A clean capital structure with clearly defined expectations (i.e. valuation) among stakeholders makes structuring a deal and getting to close easier. In some cases, it makes the difference between closing and a failed transaction. In some deals, the reason to sell or recapitalize the company is to resolve shareholder issues …but where there is litigation or unresolved claims against equity, it may make sense to address issues before you go to market.

Alignment and implementation of activities in the areas above in preparation for an ownership transition or capital infusion can greatly increase the ability to attract the buyers or investors desired and the likelihood of getting a deal done, while at the same time increase the value of business.

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