CHAPTER 1

Value ABCs

Yet, knowing how to get there—to create value—still is not common knowledge. The goals of trusted advisors should include helping clients build and create value by ensuring they're aware of how to enhance their intangible assets' value and the options to do so. Advisors must also recognize owners have limited time to shepherd growth, so having a plan is insufficient. Having resources to execute the plan is what's needed. Successful business owners and their advisors already know it's not simply selling more services and products profitably.

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Let's be clear from the beginning. Tracking revenue growth and profitability oversimplifies the complexity of an operating business. Doing so fails to examine the influence of invested capital. Invested capital examines both the use and optimization of a company's assets and liabilities (debt and its leverage as well as its risk sharing attributes). Here is a simple example: If a company has reasonable growth and profitability, it does not necessarily follow that it has performed its cash, accounts receivable, or inventory management well. It also follows that if these tangible assets have not been adequately considered, then what about the intangible assets such as human capital (i.e., governance, relationships, and knowledge) where such attributes are not found on a financial statement, but clearly have a significant impact on performance and value?

It stands to reason that most company founders understandably confuse their roles as owner-investors, officers, and employees of their companies. They may not have had the benefit of more rigorous financial training. However, what is the excuse of business advisors of all kinds who have a fiduciary duty that is greater than selling a service or product. For example, how does an owner allocate assets if she or he doesn't have a full understanding of

the risks and value of one of their largest assets—the company? How does financial reporting for tax purposes help create more intangible value? How do rates and terms alone impact the overall business in order to be more competitive in its marketplace?

Value is more than a number. The previous paragraphs ought to give pause. If value were as simple as affixing a number based on a universally accepted formula, there'd never be any disagreements between owners and the IRS, between buyers and sellers, and between any other interested parties. This is especially true for private and thinly traded public companies. The most common way to determine value is by gauging the rate of risk (return) associated with an asset's ability to generate free cash flow—and that leaves room for a lot of gray area (whose idea of risk? what period and duration of time?).

Arguably, that is where intellectual rigor and due diligence that looks beyond financial statements and forecasts is required. Mastering operational risk identification, measurement (*benchmarking*), and management are musts.

In *Driving Your Company's Value: Strategic Benchmarking for Value*, Michael J. Mard expresses, "Management must understand that a focus on value creation is a holistic endeavor that is constantly and consistently applied."[1]

Return on invested capital (ROIC) and strengths, weaknesses, opportunities, and threats (SWOT) analysis as well as associated due diligence are important considerations of value building and creation. Such analyses can and should provide benchmarks including soft and hard measures (human and financial capital). An example of a soft measure would be employee morale. A hard measure might be annual staff turnover. Common performance metrics are:

- Linked to strategy
- Clearly defined
- Understandable
- Easily measured
- Few in number
- Reported regularly
- Consistent follow-through
- Openly shared
- Predictive in nature
- Developed by everyone
- Team or unit based
- Tested against behavioral outcomes
- Assessed and modified regularly
- Linked to compensation

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So, a value is determined by establishing economic benefit, such as profit, net income, EBITDA, or cash flow. That's the numerator. Let's say it's $10 million. The remaining variables are growth and *risk* or the denominator stated as a percentage.

If the risk measurement was opined to be 25 percent (expected investor return), then the equation would be $10 million/.25 or $40 million in value. The lower the risk, the higher the value.

So, let's apply 20 percent instead of 25 percent to prove this point, of lower risk. The value would be $50 million or $10 million/.20. Stated another way, using 25 percent is the same thing as applying a price multiple of 4× or four times. Using 20 percent is the same as applying 5×.

So, while seemingly straightforward, the tough part is "What is the risk (multiple)?" This issue is at the heart of what drives investor expectations and the difference between skilled research and analytics versus an otherwise expensive, unsupported result. Thus, the lower fee for services does not matter if the value is incorrect or unsupported.

Behavioral finance does play a role in the valuation process. It's more difficult to discern value in private companies, where data is not as easy to come by compared to their public company counterparts. At the center of it all, does the company's upside investment potential outweigh its perceived level of risk?

Therein lies the Achilles' heel of valuation: making assumptions of risk and future economic benefit. It behooves anyone with a stake to ensure adequate empirical factors are considered. This means that while legal and financial issues are relevant, operational and human capital issues are often overlooked and inadequately portrayed—and that omission can significantly impact value.

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Keep in mind there are assets that are seen and reported. These are tangible assets. What a business appraiser is most often retained to opine is the unseen or *intangible* asset values. A successful business has an ever increasing part of its value associated with intangible assets, such as, but not limited to, *goodwill*.

A simple illustration is the comparison of public companies Wells Fargo Bank and Bank of America six-plus years after the Great Recession of 2009. The reported price to book value (P/BV) of Wells Fargo and Bank of America was 1.69× and .82×, respectively. This means the former's price multiple is more than twice the latter's.

More importantly, Wells Fargo enjoys intangible value (as an operational primarily asset-based holding company that exceeds 100% of its book value). That additional value is all intangible. This is likely associated with solid client relationships and reputation. Meanwhile, Bank of America's value is actually below its book value as of this book's writing.

This is not good as is suggested by Wall Street analysts who recommend a "Buy" for Wells Fargo and a "Sell/Hold" for Bank of America. Also, the companies' measured volatility compared to the industry/sector, with a 1.0 being the median and over 1.0 being more volatile (*risky*) and below 1.0 being more stable, further proves the point. Bank of America's volatility (*beta*) was 1.59 as compared to Wells Fargo's 0.86.

CAPITAL AND RISK

Company size can be a significant consideration when it comes to risk, especially with regard to securing capital. As you might expect, larger companies usually have more options and better access to the capital markets as well as better rates and terms. A $1 billion company may have funding sources bending over backwards to provide financial support while a $25 million company may need its owner to make a personal guarantee to be considered for a loan/credit facility.

The less risk perceived, the better rates and terms offered. That can pay huge dividends for larger companies, with which capital sources, such as banks, are more likely to share risk. However, size is not an absolute because growth and niche market dominance are examples of factors that could suggest a smaller company may have the potential of less risk and higher value. Sharp company owners have an idea what their company-specific risk rate is and how to spread risk by having debt allowing the lender to share the risk.

Let's use for illustrative purposes only the previous example of the $50 million company with the $10 million net cash flow and an assumed 20 percent risk rate. Let's assume our research of comparable companies indicates the optimal level of debt to equity is 50/50. So, we determined that 50 percent has a 20 percent rate for equity. This would be shown by (1 – .50).20 = .10 or 10 percent allocated to equity.

Let's then say that interest rate from the lending source is 5 percent and since interest expenses are tax deductible, that the combined state and federal tax rate is 40 percent. That means that the true cost of capital is (1 – .40).05 or 3.0 percent. Since debt represents half, we now have our new rate of (1 – .50).03 or 1.5 percent. The 1.5 percent debt rate is combined with the 10 percent equity rate for the *weighted average cost of capital* (WACC) of 10 percent + 1.5 percent = 11.5 percent. This is 42.5 percent lower than the 20 percent rate or risk for equity alone without debt. This improves the market value of invested capital by sharing risk with the note holder.

Remember, the lower the risk, the lower the rate. The lower the rate, the higher the pricing multiple and value.

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Finally, assume the $25 million debt allows the company to produce twice the widgets in half the time, reducing labor expenses. So, despite the new interest expense and repayment of principal, the increased profits are $15 million versus the $10 million.

This means the value of the company is $15 million/11.5 percent or $130.5 million (rounded) less $25 million in debt or $105.5 million in value. This is more than twice the $50 million value even prior to finding other areas where risk may be mitigated and/or minimized. This is why as a strategic value architect, it is possible to claim that in as brief as 24 months a company can feasibly increase its value by 100 percent and often more. Obviously, there are myriad other ways to accomplish this either by organic growth or through acquisition as long as synergies are achieved.

Needless to say, overleveraging may result in high sensitivity to declines in growth and inadequate cash flow to service debt. Most seasoned CFOs know leverage is a single arrow in the business's quiver to shift or reduce risk.

Yet, knowing how to get there—to create value—still is not common knowledge. Keep in mind the founder/owner is a rare breed. She or he is thinking "what if" through the opportunity-lens; whereas, advisors often think "what if" through the risk lens. Therefore, the goals of trusted advisors should include helping clients build and create value by ensuring they're aware of how to enhance their intangible assets' value and the options to do so. Advisors must also recognize that owners have limited time to shepherd growth, so having a plan is insufficient. Having resources to execute the plan is what's needed. Successful business owners and their advisors already know it's not simply selling more services and products profitably.

Here's the more surprising issue to make the point. Let's say it takes $500,000 in advisory expenses to achieve this feat of an extra $50 million in value. Who would say "no" to the proposition of for every dollar paid $100 is returned? If a prospect or a client or an advisor says "not interested," then they may not be ready to invest in themselves.

The point here (as will be explored further in Chapter 2 addressing the focus on trusted advisors) is the discussion needs to be reframed from hourly rates (fees for service) to value, milestone success, participation fees, and/or project billing. Otherwise, there is no perceived connection between services rendered and value created. (**Author note***: I like a combination of project and participation fees as it conveys to the client that I have skin in the game and the client's success is my success*.)

UNDERSTANDING ASSETS

In just the last decade, current theories (such as modern portfolio theory on a global stage) and methodologies about risk and value have undergone

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more scrutiny, and may be woefully inadequate to ensure that accurate, fully supportable valuations will consistently be produced. Let's look at a common scenario of asset and equity level risk:

> A partnership owns an apartment building, so equity can be unitized into partner interests. This is done so owners hold equity in the partnership versus directly in the asset (the real property). This can be done for business reasons such as smoothing investment jitters by having a minimum holding period, asset protection, and tax avoidance.
>
> So the first question that needs to be addressed is, what's the value of the asset? A real estate appraisal will provide a figure. Sharp business appraisers will want to know more before valuing the equity held in the LLC.
>
> They'll want to know associated tax liability of capital gains (e.g., the building was purchased for $200K and is now appraised at $1MM). This will also provide guidance as to the annual capital appreciation and not simply the income generated. Both are needed to determine total return. Surprisingly, it is common for this information not to be requested. A solid analyst will want to know whether tenants are on month-to-month or multiyear leases, and if any potential liabilities exist (e.g., failing to transfer the title to the LLC) or the manager is older and possessed most of the investment savvy—all risks that can have a negative effect on the equity value. The analyst may also wish to consider the real estate appraiser's assumed debt to equity developed in the capitalization rate as the asset held may not be financed at all (debt free) or is paying an interest rate that is not at market.

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So, the first lesson here is to understand the underlying asset level risks before making financial decisions based solely on a real estate's appraised value. The second lesson is that equity level risks that support investor concessions, referred to as *premiums* and *discounts*, are all too often oversimplified by the advisor who requested them as may the business appraiser providing the partnership interest equity valuation services.

The intellectual rigor would have to explore what is the level of direct ownership expectation risk/return of the asset. If the buy and hold is traditionally seven years, what portion of return is derived from growth/capital appreciation and what is from yield/income?

What are the asset class rate/risk norms for this holding period? If the asset is held in a wrapper like a corporation or partnership, how do bylaws

and operating agreement provisions impact the equity ownership in addition to the operating risks?

So, an adjustment such as lack of control or lack of marketability discounts without a discussion of investor expectations (risk tolerance/aversion), asset class, pool of likely investors, and holding period is absent the intellectual rigor a skilled business valuator is supposed to consider to demonstrate the adjustment to the impaired equity value makes sense and is well supported.

We'll be spending considerable time in Chapters 7 and 8 on risks at the company level, so suffice to say, more robust reports that address legal, financial, and operational risks will examine client and advisory involvement that can both establish a benchmark value, but also are risk factors impacting the value at the asset, entity, and equity levels.

This would also require not only examining the company against itself, which is referred to as a trend analysis, but correctly utilizing industry comparative data to determine the level of operational performance. Such analysis is often based upon industry and company revenues and/or asset size.

This will be addressed in greater length in Chapter 9 for my appraisal brethren and those relying on and reviewing business appraisal reports.

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PLUGGING THE GAP

How does so much get missed in the valuation process and why are so many opportunities to create value overlooked? There is plenty of responsibility to spread around. The appraisal profession could do a better job articulating its offerings and uses. The standards of practice could be strengthened. Business owners and executives could seek an investment in quality advisory services.

In *Cracking the Value Code,* Richard Boulton states: "Boards of directors need information about all assets that drive value so that they can properly discharge their duties of stewardship and governance."[2]

The advisors who most commonly serve business owners could strive to better understand the valuation work product and its utility. Peter Drucker, a well-regarded academic and management consultant, states: "If you want to do something new, you have to stop doing something old." Academia could emphasize the importance of private capital markets and methodologies applied in valuing private companies.

However, another plain truth is most trusted advisors—attorneys, CPAs, bankers, insurers, and so on—suffer from technical myopia. They focus on their products and services and assume another professional will take up where they leave off. "It's not my job" and the risk of losing client

revenues because of an unwillingness to learn the merits of other advisors plagues most professions.

We're almost all guilty of this and we suffer as a result. Worse yet, the client suffers the most due to the ad-hoc manner information often received from various advisors' lenses. The way to change this is also fairly straightforward: Owners and advisors need to elevate themselves to create better alignment on behalf of company clients' ecosystems with a focus on creating value. That is what a successful strategy is supposed to achieve: enhanced shareholder value.

The bar needs to be raised. Otherwise, as Michelangelo warned, "The greatest danger for most of us is not that our aim is too high and we miss it, but that it is too low and we reach it."

It may be best to put people in the same room at the same time, something that will eliminate conflicting advice and facilitate having robust discussions about value creation strategies and their implementation. As will be shared elsewhere in this book, this often means including family, vendors, and clients as part of the holistic approach that becomes embedded in the company's cultural DNA.

NOTES

1. Michael J. Mard, *Driving Your Company's Value: Strategic Benchmarking for Value* (Hoboken: Wiley, 2004).
2. Richard Boulton, *Cracking the Value Code* (HarperCollins, 2000).

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