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IT MUST BE WORTH TWICE THAT ... I HOPE?
Understanding A Company's Value

Overview

Valuation of a company is a subjective process. Business owners and managers would benefit greatly by thinking about the company's future and consider how an outsider would estimate the value of the business. Managers who put themselves in investor's shoes maximize the likelihood that the business will be worth more but perhaps even more importantly that the businesses fundamentals will be sound and sustainable.

Here is a typical scenario: a CEO or owner has built a business over the long-term but has not put in place a realistic plan for the future of the company. At some point these owners cannot or choose not to continue leading the business and begin to consider the best path forward.

Some of these owner-operators are fortunate to have a succession plan in place. Or perhaps they have recruited and built a highly functioning management team to run the company. Regardless of how well prepared the company is, now is the time to describe the company's value and more importantly understand what determines that value. If an owner knows that, he or she can identify three to five key areas to enhance that will increase and stabilize the value of the company. Here is a straightforward way for a management team to approach this and to develop a roadmap to improve the business. Viewing the company in this way may translate into receiving a higher value on better terms from investors considering investing in the company.

Establishing a Value

Determining the valuation of a business is not a straightforward exercise. To be sure, the tools of valuation are readily accessible, but the judgment and perspectives of the future count more than a spreadsheet.

If a business owner were to ask three different investors the value of the company, he or she will often receive three (wildly) different responses. By considering how an investor would evaluate a company, business owners can focus on ways to unlock the value in the company or, at a minimum, stabilize its value.

Valuation is a subjective process because investors and owners have different expectations about the future. A company's value, like any other asset, is worth what someone will pay for it. To that end, how might a potential investor think about valuing a company? At a broad level, investors generate a point of view on the attractiveness of the industry, the company's operating model and its management teams' abilities.

Choose the Market Wisely

The prospects for a company are heavily influenced by the industry in which it competes. Consider that in the United States during non-recessionary times the typical GDP growth rate is between 2% and 3%. For a company to maintain its position it must also grow at that same rate; however, for a company to increase its market share it must grow above its industry's growth rate. While a company might not directly influence its industry growth rate it can redirect the business to higher growth sub-segments or institute strategies to win market share by out-maneuvering competitors.

Market Dynamics

Being in a high growth, attractive industry correlates highly with valuations. For illustration purposes we select two industries: biotechnology (high growth) and diversified utilities (low growth). Table one reveals that while both industries have somewhat similar profit margins, investors are willing to pay more than four times on an earnings and book value basis for a biotech firm than for a diversified utility.

Investors expect that biotechnology companies will grow dramatically quicker than utility companies. Why? A utility will only grow at the rate of population growth, barring any evolution in energy creation. A biotechnology firm may discover innovative products that create new markets. Of course, investors have additional views that inform their valuations such as return on invested capital or intellectual property rights protection.

Table 1
Paying For Growth

Metric	Biotechnology	Diversified Utility
Price to Earnings	57.8x	13.9x
Price to Book	7.4x	1.8x
Net Profit Margin	11.9%	8.5%

Growth rates alone do not justify the attractiveness of an industry. An industry that requires specialization makes it difficult for new entrants to enter the market since they may require expensive factories or regulatory approval to compete.

Industries that have long-lasting relationships with their customers that results in repeat business or recurring revenue such as monthly cable service command higher prices than companies that sell non-branded commodity products such as door hinges.

Industry Prospects

An industry's current structure tells only a portion of the story. Industry prospects inform investor's viewpoints. Consider the ongoing debate in the United States on health care legislation and reimbursement rates to providers. For instance, the home health care industry is experiencing a measured amount of concern about future reimbursement rates from Medicare. These industry participants are assessing the attractive demographics of the aging baby-boomers against a potential decrease in reimbursement rates. Some investors may alter their view from their current perspective and either make decisions based on their best assessment of the situation or more likely take a wait-and-see approach before transacting in this industry. An uncertain regulatory future dampens valuations.

Size and Composition

The size and composition of an industry also play a part in investors' expectations. A case can be made for identifying sufficiently large industries that are highly fragmented as attractive spaces. To be the market leader in a $50 million industry does not excite investors; however, a five billion dollar industry where no competitor commands more than 5% market share suggests ample opportunity for companies to double or triple in size in short order. A small player in a large, growing, and fragmented market is quite attractive.

What An Investor Would Actually Be Buying

Let's assume that an investor has researched a company in an industry of interest, and decides he likes what he sees. The investor may have concluded that it is a large and growing industry, that sufficient barriers to entry exist, and that the economic relationship between the industry and its customers is compelling. Now the investor turns his attention to how the company positions itself within the industry. Is the company a market share leader or laggard? Is the company the low-cost provider or have they segmented the market and pursued a high touch, service-oriented model. Are the financial results above or below the industry median?

Allocation of Capital

The company has made decisions to allocate its capital and resources to a portfolio of products and services. Accordingly has this set of decisions been a good one in which the firm has maximized its resources? On one extreme the firm may have captured an attractive niche and is providing a valuable offering that generates attractive returns on invested capital. Return on invested capital[1] is a measure of how effectively a company is able to generate cash flow from its invested capital.

Conversely, the company may have pursued a more crowded segment of the industry that requires they compete on price alone. In this scenario the company may experience below average profits. Investors assess how well the company is positioned and begin to imagine ways to optimize the company's portfolio of offerings to increase profits.

Table 2
Characteristics of An Attractive Industry

Characteristic	Enviable	Unenviable
Growth Rate	Greater than 10%	Little to no growth
Industry Size	Large and fragmented	Small with few competitors
Barriers to Entry	High	Minimal or non-existent
Revenue Type	Recurring or repeat revenue	One-time transactions
Unique Characteristics	Special know-how or assets required to operate	Impending legal or regulatory changes
Alternatives	Few, if any, substitutes	Many substitutes
Degree of Complexity	Low	High

Investor Beliefs

On one hand, an investor may believe that he can improve the prospects of the company and capture untapped opportunity. On the other hand, the investor may believe he has uncovered a well-oiled machine that is generating outsized profits without much room for improvement. Next an investor will examine the company's ability to grow and compare that to its industry's prospects. If the company is

[1] Net operating profit less adjusted taxes divided by invested capital

growing faster than its industry, one wonders if this is sustainable. If it is not growing as quickly as the industry, why not?

Assuming that an investor finds the business's position compelling and sees opportunity to maintain or enhance the company he will focus on its financial results. Does the company's top-line growth, revenue, demonstrate consistent growth or is it volatile? Is growth accelerating or decelerating and if so, why? Have margins remained fairly constant or is there significant variability year over year? Perhaps the company has seen its product inputs increase. Is this a temporary result or a long lasting one? Consider fuel prices. When gasoline hovers at historical highs many industries contemplate their demise. When gas prices return to historical norms, companies dependent on transportation benefit, but for how long? These factors are incorporated into an investor's view of the company.

Customer Relationships

Customer relationships and the structure of them matter. Is this business reliant on one or two large customers? Said differently, what is their customer concentration risk? Do the top five customers represent 80% of sales? Or do the top 80 customers represent 5% of sales? Revenue from a diverse and un-concentrated customer base trumps having one or two clients. When those customers call, for whom do they ask? Do they ask for the business owner or do they have a relationship manager appointed to the account. Investors like to see a company that is not overly reliant on a key client or a key individual.

Table 3

What to Do Now?

Developing a perspective about the future poses challenges because of how quickly markets evolve. If nothing else companies should continue to evaluate three key areas:

- ➡ How is the industry I am competing in evolving?
- ➡ How well is the company positioned in that industry to protect or expand its market share?
- ➡ Does the company have the proper resources in place to adapt and manage based on answers to the first two questions?

More specific questions that need to be understood include:

- ➡ What is the Company's return on invested capital (ROIC)?
- ➡ How scalable is the Company?
- ➡ What is the required investment to achieve the growth targets?

Product Value

Do customers need the company's product or service or is it possible to delay purchase or find a substitute? A company that provides mission critical services such as payroll processing is a must-have product. While there are many providers in the marketplace, it is a difficult process to migrate to a new payroll provider. In that kind of business, companies have a fairly good understanding where next quarter's revenues are going to be generated. A company that provides printing of brochures and marketing materials has a very different relationship with its clients. With limited visibility of when a customer will next hire them, predictability of revenue and income is far more challenging. This notion of recurring revenue is so important in distinguishing a business from an attractive one to being an all-star.

Capital Requirements

As a company services its customer base and identifies avenues for expansion, investors assess the capital requirements of a business. For instance, a firm that provides medical billing software requires less annual investment than one that manufacturers tractors. The software firm occasionally upgrades its software and reinvests a portion of its profits to do so. A manufacturing entity is reinvesting a much higher percentage of its profits to maintain its equipment and to acquire additional assets so that it may expand and service more customers. Given a choice, many investors would prefer a company that requires minimal capital expenditures to grow than one that requires a high degree of capital expenditures to grow. This notion brings us back to the earlier mentioned concept of return on invested capital. The profitable software firm will likely have a much higher return on invested capital than will a manufacturing firm.

Degree of Complexity
The degree of complexity of a company is also a factor for attractiveness. Complexity can refer to a company's supply chain, such as Walmart where there are many vendors to coordinate and manage. A second example is a company that is spread across many locations with each requiring different licensing or permits to operate such as an insurance company. As the business looks to grow, these challenges may substantially limit the company's ability to expand.

The manufacturing process of a biotechnology company may be very complex and require specific conditions and supplies to meet requirements and safety guidelines.
A software provider may need to provide after sale servicing that requires a highly trained customer service function. As complexity increases, the risk of not delivering product or service to a client also increases. Conversely, a company that has assembled an elegant solution to deliver a complex offering may find itself in an enviable position compared to its competitors.

Management: Focused Resources
Management teams that are well structured contribute to the attractiveness of a company. Often in smaller companies, and in some large, influence and leadership resides with a small group, often one or two key employees. Replacing this leader is a task most investors would avoid.

Roles and Responsibilities
More appealing is a management team that is well defined and organized. A company with leadership spread across functions – sales, manufacturing, finance – reporting to the company's president is appropriate. These functional leaders should have autonomy
to present options and recommendations and to bring about change.

Business owners should reduce the operating risk of a company by sharing responsibilities across individuals. This approach is a strong motivator for employees and also gives potential investors comfort to know that there are resources within the company that can be relied upon to manage and grow the business over the long term.

Objectives and Goals
Companies that are owned and operated may have different objectives than investor/shareholder owned companies. An owner-operated company may pursue a lifestyle- oriented approach in which they manage the business to support a certain lifestyle. Notions of return on invested capital, cash flow maximization and innovation may be trumped by a desire to earn a reasonable income that supports a certain lifestyle.

Some investors are willing to step into these situations and navigate the challenges of partnering with or replacing the existing ownership because the investor believes the company has been under managed. An investor's expectation may be that they can supercharge the business and dramatically improve the business' prospects.

Potential Exits

Finally, an investor is always considering how they will exit the investment. As they evaluate the management team and either retain existing or recruit new management, it is with the focus of how will this team increase dramatically the prospects of the business. Is the team prepared to execute its organic growth potential (the day-to-day operations) and if so is the team capable of identifying transformational opportunities (such as new product launches or acquisitions) to change the growth trajectory of the business? And if the team is capable of achieving those goals, how quickly can they be realized?

Conclusion

Investor groups dedicate teams to identify attractive sectors for them to pursue. They may already have a platform company in place and are seeking add-on acquisitions to bolster the platform in preparation for a sale of the business. Or they may be looking to enter a new market and believe they have identified an attractive industry.

Business owners would be well served by preparing their business for an eventual sale even if a sale is not intended. Taking an outside-in look may identify opportunities to improve the business and make it more stable. And if down the road the decision is to sell, the hard part will have already been completed.

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