

What creates true value in a business?

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One of the most important responsibilities as a business owner is to create and enhance the value of your company. The business is often the most substantial asset that you hold, so you deserve a more-than-adequate return on that asset given the risks of owning it.

While “return on investment” is a straightforward concept, “value” may be more vague. Successful business owners recognize value in two ways. The first way is through your compensation, net income, and dividends/distributions received throughout the course of owning the business. The second way is what the business is worth when you elect to sell your interest in the company. These two paths are highly interdependent. However, for purposes of this discussion, we’ll focus on what creates and drives the value at the time you sell or “harvest” the business.

In my prior blog posts, we discussed the fact that value is generally a function of the free cashflow of the company times some multiple ([“The Crux of Multiples” Part One](http://www.ibmadison.com/Blogger/ExitStageRight/March-2018/The-crux-of-multiples-in-business-valuation/) and [Two](http://www.ibmadison.com/Blogger/ExitStageRight/March-2018/The-crux-of-multiples-continued--One-company-many-multiples/)). Value is the intersection of risk and reward. Buyers pay more for companies when the potential future rewards outweigh the risks. While this is obvious, its simplicity is deceptive.

Rewards are traditionally based on potential future cash flows. Risk is represented by the multiple, which is made up of a variety of market, economic, industry, company-specific, and many other risks. Company-specific risk is often the largest component of the risk factors.

**What drives *your* company-specific risk?**

Company-specific risk (CSR) is the cumulative risk associated with a given company’s business model and operation. Other than potential future cash flows, CSR is the most important factor for a business owner to understand and manage. *It alone makes or breaks the potential for any deal*.

Think about the variety of risks that you face and deal with every day. Your customer base, compliance requirements, employee issues, product quality, etc. all impact your success today and in the future. Businesses that intentionally manage these risks have lower CSR and greater relative value.

These are often referred to as “value drivers.” Value drivers, managed well, make a business more successful in the hands of the present and future owner. The stronger the company’s value drivers are, the more profitable and sustainable it is, making it worth more. If value drivers aren’t managed well, it may mean that the company isn’t saleable or transferable.

Important value drivers include, but are not limited to:

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| ***Management team*** | Do you have one? How capable are your managers? Do you trust them to make important and operational decisions without you? Do they trust themselves to make the decision or do they rely on you? |
| ***Diversification*** | How deep is your customer list? How much of your revenue comes from the top few customers? How much of your gross profit? How big of a setback would you suffer if your top customer(s) went elsewhere? Similarly, how reliant are you on particular suppliers? What would be the impact if your top supplier went out of business? Is there a back-up plan? How long would it take to get back to the same quality and output? |
| ***Recurring revenue*** | Companies that earn a steady stream of recurring revenue are less risky and more sustainable. Take computer software, for example. In the old days, you bought software packages. You paid big bucks once and then kept a far less expensive maintenance agreement. Today, many savvy software providers only offer a recurring revenue model. They own the software, not you. You now pay a handsome SaaS license subscription every year to use it. |
| ***Product innovation & quality*** | Obvious, yes, but may be challenging to maintain. Technology and innovation accelerate around us every day. Customers are increasingly discerning. If you’re not keeping up with the curve, providing exemplary quality and innovating on your own, your relevancy is at risk. |
| ***Performance & growth*** | This, too, speaks for itself. If you’re not growing and/or not profitable, sustainability is compromised. |
| ***Business plan*** | Business plans aren’t the end all and be all as a value driver. It’s the intellectual discipline used to create and accomplish one as a management team that drives the acceleration of value. |
| ***Systems & procedures*** | How much of what you all do is documented versus in your heads? Are colleagues cross-trained and able to back each other up? Are there business continuity and disaster plans? Play scary monsters for a moment. Consider the worst possible scenarios, such as a natural or personal disaster. How well will the business recover? Will the business recover? |
| ***Company intellectual property & other intangibles*** | If you have bona fide intellectual property, such as patents, copyrights, trademarks, etc. you have hopefully formally protected them. If you haven’t, consider it. They have value to you and any future owner. If you don’t have much in the way of bona fide intellectual property, you’re not off the hook. Beyond the systems and procedures noted above, you need to take intentional steps to protect the good will you have built in your company, such as your customer list, brand, unique culture, talent, know-how, and so on. |

Do you know where your company sits? How strong are your value drivers? If you don’t know, find out. Determine your baselines. Commit to pulling your key managers and advisors together to do a facilitated assessment on a regular basis. It is the starting gate for creating and accelerating your value and cash flows, now and at harvest time.