

## Thoughts on Improving Your Company's Valuation

**By:**

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### Why should a business unit exist?

Much has been written about why a business unit—which could be a complete business, a division or subsidiary, a product line, manufacturing plant, store, discrete geographical territory, etc.—should exist. The most important reason is to get a premium return on the fair value of the invested capital in such unit. The premium should be something in excess of the returns available on relatively safe, passive investments, such as U.S. government securities, AAA-rated corporate bonds, etc. The greater the risk of the investment, the greater the premium should be. Remember, it's the return—the result of dividing a measure of income, i.e., net income, operating income, EBITDA, etc., by the invested capital—that is fundamental to maximizing the value of the enterprise.

Profitability drives the numerator, and good working capital techniques and efficient investment in tangible assets drive the denominator. Whichever metrics are used to track change, they must be used consistently. The business objective is to increase the percentage rate of return over a reasonable time frame. An important and easily applied formula to measure the financial rate of return follows:

$$\text{Rate of Return} = \frac{\text{Income}}{\text{Investment}} = \% \quad \text{How are business units valued?}$$

"Greenfield" or start-up activities are usually valued at the cost of all assets plus all startup costs, including losses, until they reach a normalized operating status. The sum of all such startup costs and assets employed forms the investment, and it is this number that becomes the denominator in the formula above that is used in computing the expected return on the project.

To determine the return for an established business, dividing the measure of income by the investment in net working capital and tangible assets (usually for the lower or base level of return) would be appropriate, and the result would be compared to the capitalized value of the historical and normalized free cash flow, which usually results in the higher-side valuation. The "capitalization rate," also referred to as the "cap rate," is usually determined by looking at relevant comparisons that are available, and may be developed from the company's own internal data as well as from a variety of public sources.

Over time, the rate of return will be the primary driver in the capitalization rate. If the historical rate of return on the invested capital is growing or a credible plan is developed to grow it, the cap rate will usually move up and therefore increase the business unit's valuation. This sounds easy, but it's not.

### Who should be concerned about valuation?

In general, all of a company's stakeholders including customers, vendors, employees, lenders and equity owners who interact with a business unit should be concerned about both its performance and valuation. Unfortunately, it is usually the owners and perhaps the lenders who are the ones most frequently tracking it, and in many cases the measures of return are not monitored frequently enough nor are the right measures used to determine levels of success, resulting in lower-than-expected valuations. In addition, in too many instances such vital information is often held too close to the vest by senior management and not shared with the individuals charged with the business unit's profitability.

The repercussions of this antiquated approach to management permeate the organization, and its effects can range from poorly informed investment decisions that result in too-heavy investment in working capital, unprofitable products and/or customers, and sub-optimized cash flow, all of which translates into reduced enterprise value. Furthermore, without having the business unit's managers' intimate participation in and understanding of the unit's financial returns, the organization risks improper evaluation of its employees' performances, inappropriate compensation decisions, low morale and ultimately higher turnover, which is a significant cost to the enterprise and a direct contributor to lower corporate valuations.

For the shareholder—especially a shareholder of a private enterprise—who should always have some focus on “exit strategy” issues, the portion of the business's value that's attributable to the shareholder is ultimately the focal point and, obviously, maximizing that value is fundamental. All shareholders should demand that an approach to, and measure of, return and value be monitored closely and updated regularly. Ultimately, the return/value the shareholder gets on the investment will be a direct function of the return on assets employed on the sum of the projects or business units that together are the business. Proper planning and measuring of a project's costs, from rollout through its lifecycle, and evaluating actual-versus-expected results, avoids nasty surprises when the shareholder's contemplated exit strategy is ready to be realized.

### **Traditional factors affecting the valuation of a business unit**

There are many factors that contribute to the value that is ultimately placed on a business unit, and the relative importance of these factors changes over time and is a function of many influences. We have listed below several of the more important elements a prospective investor would consider when evaluating such an opportunity:

- Management's understanding of the market to be served, and its ability to grow both the business and the market.
- The barriers to entry: financial, including both working capital and capex requirements; technology; logistics; threat of foreign competition, particularly sourcing if in a manufacturing environment.
- Repetitive nature of sales: generally a higher value is placed on an annuity than on one-time opportunities. In general, one of the more important attributes is the ability to grow and sustain the business unit.
- Gross margin trends: are the margins artificially high today because the business's product or service offering is unique; what guide does history provide with respect to the threats during the forecast period.
- Competitive situation: who serves the market today, what weaknesses can be exploited; what makes this business unit's *raison d'être* so intriguing.
- Political and legal trends, threats and or vulnerability.
- Management depth and track record.
- Industry comparables.
- Asset quality.
- Cyclicity.
- Predictability.

### **What is a growth business?**

In many managers' minds, "growth" means increasing levels of dollar (versus unit) sales and profits. This is certainly a measure of growth, but not the measure that necessarily results in value maximization. Instead, the "value definition" of a growth business is one that can consistently get premium returns on additional invested capital. The primary business objective is to be able to create, recognize and take advantage of opportunities for additional capital to be invested and to generate the appropriate returns on such capital.

### **Appropriate returns**

Startup activities should target and subsequently command a higher return than incremental investments in existing businesses. Why? If the expected return on the new business is the same as the return on existing businesses, why take the risk when the return on the existing business is already available and perhaps, theoretically, both guaranteed and safe. (It is critical to note that we do not believe any return on a business investment is either guaranteed or safe, and that a management team that does so is one the prospective stakeholder should avoid.)

One should also note that in evaluating opportunities, investments in hard assets that have limited uses usually get higher returns than assets with multiple uses. The contrary issue is that investment returns usually drive the investment decision.

### **Readily available capital may not be your friend**

Each business unit should be tracked, monitored and evaluated on a regular and consistent basis with the unit's managers focused on how to improve the return on capital invested. This type of continuous review will, by definition, entail evaluation of all the key operational, financial and strategic drivers inherent in the business. Therefore, one must look at "operational profitability" as well as financial return. At the end of the day, the successful business unit manager maximizes return and reduces the invested capital necessary so that it can be deployed on the next project. Points to monitor include:

- Working Capital
  - o Are the receivables collecting as fast as they could?
  - o Is the inventory turning as many turns as possible?
  - o Are we paying our vendors properly (and working with them as supply chain partners?)
  
- Are we evaluating how to improve productivity and minimize our transaction or operating costs?
- Are we working with our customers, understanding and anticipating their needs and learning what their customers' needs are?
- Are all aspects of the business unit making the optimum profit contribution consistent with the investment made?

The big challenge is how to take a company's current return and move it up over a reasonable period of time. By applying the above analyses to a company's various business segments, opportunities to improve performance and thus boost return will become apparent. Once the return is headed in the right direction, consistent monitoring of working capital investment, capex initiatives and transaction costs is critical. In today's environment, lenders are very aggressive and capital, by historic standards, is relatively inexpensive; betting that this environment will continue is a risky play.

Capital availability and its cost can entice managers to make what would otherwise be poor investment decisions that result in low returns, as measured against historic standards. It's the return one can get on invested capital - not always its availability or cost - that is the key to maximizing value!