Key Wealth

Key Family Wealth – Business Advisory Services (BAS)

Identifying Drivers of Transferable Business Value

Breaking down business value

The most significant factor that impacts a business owner's ability to leave their company – successfully or not – is creating a company with transferable business value. Business value has become a bit of a buzzword, often exchanged frequently and mindlessly in business conversations. But what really drives value in business, and how do you identify the key value drivers of a business? A common misconception about business value is that it is determined solely on financial performance. However, in most cases, the numbers alone do not always tell the full story. This is why it is crucial that business value be transferable.

Both general business planning and transition planning operate with the intent to reach a similar conclusion at the end of the day: the business owner may sell their business when they want, for the money they need, and to the person they choose. We will examine where value is generated and where there are opportunities to increase transferable business value, which include components that are not captured in the financial statements that are typically referred to as "value drivers."

Taking a look at the present

Before any work can be done to improve business value, an important first step for the business owner is to obtain an accurate understanding of both the value of existing resources, as well as the amount of resources needed to reach their target value of the business. Almost always, there is a noticeable and measurable asset gap between the two.

To move past the present and closer to the finish line in the future, a lot of business owners must work to make dramatic and drastic changes that will grow business value and increase cash flow. All the while, they need to keep their value gap in mind as work is done to bridge it.

Transferable value defined: Potential buyer and business owner

At the end of the day, potential buyers are the arbitrators of business value. The business value drivers that have

been determined to be the most important have been vetted through the lens of sophisticated buyers as they buy companies based on experience, competition, etc. It is important for a business owner to note that even if they fear their company is too small to be noticed, every buyer wants similar qualities in a business. These qualities are the value drivers, each of which work toward creating transferable business value.

Transferable business value can be defined as what a business is worth to someone else, without the owner. Consider:

- Insiders (employees) would not want to risk their personal assets if the business could not run without the owner.
- Children could not take on the company if they cannot manage the operations without the parent(s).
- Third-party buyers would be misled to purchase a company that cannot function once the owner departs.

Finally, family members of the owner might be left unsure of how to take care of the company, or risk losing their source of income, if something were to happen to the owner. Transferable business value is the determining factor of a business owner's successful transition — regardless of transition path.

Value drivers

So, how does a business owner identify value drivers of a business? How do they prepare a business for an eventual sale or transfer?

Next-level management

Simply put, buyers are purchasing the ability of a company's management team to perform without the owner. Management is arguably the most crucial value driver, because in the end, management oversees the installment and growth of all other value drivers.

It is up to the owner to decide whether existing management has the capability to grow the company at the rate required to bridge the value gap, whether they could if provided more training, or if new management is necessary. Oftentimes, finding new leaders who have experience working in larger settings with customers, vendors, advisors, consultants, and other market leaders is what will allow the company to improve to the degree needed to reach the owner's transition goals.

With either option, it is key that the business owner works to instill leadership and motivation to top management so they can work towards goals with the company mission in mind.

Operating systems that improve sustainability of cash flows

The creation and documentation of standard business procedures prove to potential buyers that a business will continue to be profitable after the sale or owner's departure. Buyers look for systems and procedures that promote operational efficiency, and if this value driver is absent or weak, buyers tend to move on.

Diversified customer base

Potential buyers and investors pay closer attention to a business' customers than the seller might think. A company that has high transferable business value has a healthy mix of customers that lie along various points of the buying stages.

A common red flag to potential buyers that might decrease business value is a company that has a single buyer that accounts for more than 10% of total sales — or whose top three customers generate 40% of all sales. Customer concentration must be avoided, as it is a major risk factor, regardless of transition path.

Proven growth strategy

Growth can sometimes be hard to articulate. It is important to have a written plan that defines growth in the context of industry dynamics and the market's demand for the company's product or service. A detailed and well-communicated growth plan attracts buyers if they can see what measurable growth has been made in the past and what actions are outlined to achieve future growth.

This value driver ties hand-in-hand with next-level management as those managers, with the owner's input, will be assigning the responsibility and deadlines to complete strategy-related tasks.

Recurring revenue that is sustainable and resistant to commoditization

The reason that revenue is a value driver is evident: If you were a buyer, you'd much prefer to purchase a company that makes money over one that struggles to report a profit at the end of the year. This value driver promotes the consideration of alternative or additional revenue streams.

On the same note, the perception of a company's product or service is important as well because if customers do not view them as commodities, there is risk of losing the customers in the face of transition. The value of a company to the consumer must fall on the company's offerings, not the company's owner.

Improving cash flows

Ultimately, all value drivers contribute to stable and predictable cash flows. When it comes to cash flows, management needs to have the goal of increasing productivity and decreasing cost. While this is no simple task, this value driver depends on the effective execution of the other value drivers.

Demonstrated scalability

Scalability should be a major focus of one's company, because it is the quickest way to grow cash flow. Buyers demand this value driver because they do not want to purchase a company that does not have the capability to grow future earnings.

Competitive advantage

In simple terms, the competitive advantage of any company is the offering provided that is either better or cheaper than competitors. Strong brand recognition and customer satisfaction are also key factors that tie into a company's competitive advantage that will only add to a business' transferable value.

Financial foresight and controls

Many companies lack reliable financial reporting to an extent that buyers cannot track its revenue. It can also indicate that a company does not have competent management in place that can report on their financial performance. It is important for potential buyers to be able to see the projected cash flow in a way that makes sense, as well as to analyze the costs of implementing the growth plan.

Timing of transferable business value

Naturally, the sooner a business owner begins to improve their company's value drivers, the more the company will benefit. Oftentimes, if owners wait until they are emotionally prepared, they will be faced with a handful of challenges, including:

- Decreased passion and motivation to build value and push business growth
- Years of cash flow forfeited
- Decreased satisfaction with ownership experience
- Limited transition path options with more pressure riding on the challenges

For more information, please contact your advisor.